87-562

No. 87-____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

SECURITIES INDUSTRY ASSOCIATION,

Petitioner,

—v.—

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *et al.*,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Of Counsel:

William J. Fitzpatrick
Securities Industry
Association
120 Broadway
New York, New York 10271
(212) 608-1500

Donald J. Crawford
Securities Industry
Association
1850 M Street, N.W.
Washington, D.C. 20036
(202) 296-9410

James B. Weidner
(*Counsel of Record*)
David A. Schulz
Mark Holland
ROGERS & WELLS
200 Park Avenue
New York, New York 10166
(212) 878-8000
Attorneys for Petitioner
Securities Industry
Association

QUESTION PRESENTED

Whether the Order of the Board of Governors of the Federal Reserve System affirmed below, permitting a bank affiliate both to promote the purchase and sale of particular securities to the public and to buy and sell those securities as agent for its customers, violates the prohibition against the "public sale" of securities by bank affiliates contained in Section 20 of the Glass-Steagall Act?

PARTIES TO THE PROCEEDING

In addition to the petitioner* and respondents listed in the caption, the following are also respondents in this action: Alan Greenspan, as Chairman of the Board of Governors of the Federal Reserve System, Manuel H. Johnson, Martha R. Seger, Wayne D. Angell, H. Robert Heller and Edward W. Kelly as Members of the Board of Governors of the Federal Reserve System, and National Westminster Bank PLC and NatWest Holdings Inc., as Intervenors-Respondents. Paul A. Volcker, Chairman Greenspan's predecessor as Chairman of the Board of Governors of the Federal Reserve System, was named as a respondent below.

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* Pursuant to Rule 28.1 of this Court, petitioner states as follows: The Securities Industry Association is a national trade association representing more than 500 securities brokers, dealers and underwriters who are responsible for over 90 percent of the securities brokerage and investment banking business in the United States.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Petitioner, Securities Industry Association ("SIA"), respectfully prays that a Writ of Certiorari issue to review the opinion and judgment of the United States Court of Appeals for the District of Columbia Circuit entered in this proceeding on July 7, 1987.

OPINIONS BELOW

The Order of the Board of Governors of the Federal Reserve System (21a)[1] is reported at 72 Fed. Res. Bull. 584 (1986). The opinion of the United States Court of Appeals for the District of Columbia Circuit denying the SIA's Petition for Review (1a) is reported at 821 F.2d 810 (D.C. Cir. 1987).

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1 Citations herein to material printed in the Appendices appear as "____a".

JURISDICTION

The opinion of the Court of Appeals for the District of Columbia Circuit was entered on July 7, 1987. This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTE INVOLVED

Section 20 of the Glass-Steagall Act,[2] 12 U.S.C. § 377, provides in relevant part:

> [N]o member bank [of the Federal Reserve System] shall be affiliated . . . with any corporation, association, business trust, or other similar organization engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities.

STATEMENT OF THE CASE

A. The Administrative Proceedings

National Westminster Bank PLC is the fourteenth largest banking organization in the world.[3] It controls numerous banking and other financial subsidiaries world-wide, including County Bank Limited, a large merchant bank headquartered in the United Kingdom that engages in a full range of merchant banking activities, such as lending and investment banking, outside the United States.[4] In this country, National Westminster Bank PLC controls NatWest Holdings, Inc., a bank holding company, and its subsidiary, National Westminster

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2 What is generally referred to as the Glass-Steagall Act was enacted as part of the Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162, and is codified in various sections of Title 12 of the United States Code, including 12 U.S.C. §§ 24(7), 78, 377 and 378.

3 National Westminster Bank PLC is organized under the laws of the United Kingdom. As of December, 1985, the bank had total assets of approximately $104.7 billion. 72 Fed. Res. Bull. at 585, 23a.

4 72 Fed. Res. Bull. at 588, 23a; *see* 821 F.2d at 819, n.9, 18a, n.9.

Bank USA, N.A., a national bank with over $7 billion of deposits.[5]

In August 1985, National Westminster Bank PLC and NatWest Holdings, Inc. (collectively "NatWest") applied to the Board of Governors of the Federal Reserve System ("Board") for permission to establish a new subsidiary, County Securities Corporation ("CSC").[6] The proposed subsidiary would engage in the business of promoting the purchase and sale of particular securities and executing securities trades for its customers on an integrated basis, generally charging a fee only on securities transactions actually executed.[7] This request to engage in full-service brokerage (combining transaction services with investment advice) was the first such request made to the

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5 72 Fed. Res. Bull. at 585, 23a.

6 Both National Westminster Bank PLC and NatWest Holdings, Inc. are bank holding companies subject to the Bank Holding Company Act of 1956, as amended, 12 U.S.C. § 1841 *et seq.* NatWest filed its application pursuant to Section 4(c)(8) of the Bank Holding Company Act of 1956, as amended, 12 U.S.C. § 1843(c)(8). (*See* 72 Fed. Res. Bull. at 585, 23a.)

7 (72 Fed. Res. Bull. at 584, 21a.) Specifically, the application requested permission for CSC to engage in the following non-banking activities:

> (1) providing portfolio investment advice to "Institutional Customers";
>
> (2) providing securities execution (brokerage) services, related securities credit activities pursuant to the Board's Regulation T, and incidental activities such as offering custodial services and cash management services, in each case for institutional customers, and in each case under circumstances where the securities brokerage services are restricted to buying and selling securities solely as agent for the account of such customers;
>
> (3) furnishing general economic information and advice, general economic statistical forecasting services and industry studies to institutional customers; and
>
> (4) serving as an investment advisor (as defined in section 2(a)(20) of the Investment Company Act of 1940) to investment companies registered under that act.
>
> (72 Fed. Res. Bull. at 584, 21a.)

Board on behalf of any bank affiliate since the Glass-Steagall Act was passed over five decades ago.[8]

By order dated June 13, 1986, the Board approved NatWest's application in all respects. *National Westminster Bank PLC*, 72 Fed. Res. Bull. 584 (1986) (21a). The Board found that the proposed activity was permissible under the Bank Holding Company Act as being "closely related to banking" and, in light of the limitations imposed on the activity, as also providing public benefits outweighing its detriments. (72 Fed. Res. Bull. at 591, 39a.) The Board additionally concluded that NatWest's activity would not violate the "public sale" prohibition in Section 20 of the Glass-Steagall Act, 12 U.S.C. § 377. (72 Fed. Res. Bull. at 592, 41a.)

In the latter respect, the Board pointed out that the Court had permitted bank affiliates to provide separately each of the components of the proposed activity (investment advice and securities execution services) and reasoned that the combination of those activities therefore was allowed.[9] The Board also believed that the promotion and sale of particular securities would not involve any of the factors the Court previously had used in describing the "public sale" prohibition of Section 20. (72 Fed. Res. Bull. at 592, 41a.) Although the Board recognized that the combination of securities brokerage and investment advice created the "potential" for the conflicts of interest

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8 To narrow obvious concerns under the Glass-Steagall Act raised by its application, NatWest proposed to limit CSC's business to "Institutional Customers," a term it defined generally to include only financially sophisticated corporations and high net-worth individuals. (72 Fed. Res. Bull. at 584, n.1, 21a, n.1.) NatWest also represented that CSC would not "exercise discretion with regard to any customer account." (*Id.* at 584, 22a.)

9 72 Fed. Res. Bull. at 591, 41a. The Board cited *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 207 (1984) ("*Schwab*") (permitting bank holding company to acquire a "discount" securities broker, *i.e.*, a securities broker that executes trades for the purchase and sale of particular securities for its customers, but does *not* provide investment advice), and *Board of Governors* v. *Investment Co. Institute*, 450 U.S. 46 (1981) (permitting bank holding company affiliate to act as an investment adviser to a closed-end investment company).

and other hazards Congress sought to avoid through the Glass-Steagall Act, the Board dismissed such hazards as not "likely" or not "significant," given the various "commitments" entered into by NatWest and the other "conditions" imposed by the Board on the conduct of the proposed activity. (*Id.* at 595, 51a.)

The SIA filed a timely petition for review of the Board's Order pursuant to 12 U.S.C. § 1848 with the Court of Appeals for the District of Columbia Circuit.

B. The Opinion Below

The court of appeals upheld the Board's ruling. *Securities Industry Ass'n* v. *Board of Governors*, 821 F.2d 810 (D.C. Cir. 1987) (1a). The court agreed with the Board that because this Court separately has upheld the provision of securities execution services and investment advice by bank affiliates, the combination of those activities should not be prohibited. The court below noted that in *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 207 (1984) ("*Schwab*"), the Court upheld a Board ruling permitting a bank affiliate to provide securities execution services *without* the provision of investment advice, and described NatWest's proposed activity as "simply indistinguishable" from the activity at issue in *Schwab*. (821 F.2d at 814, 9a.) Although conceding that the activity fell within the literal scope of the term "public sale" in Section 20, the court below construed the opinion in *Schwab* as interpreting that term to refer only to activity in connection with securities issuers. (821 F.2d at 814-15, 10a.)

The court further concluded that NatWest's proposed activity did not implicate the hazards at which the Glass-Steagall Act was aimed, because each of the potential hazards that would arise from NatWest's activity also arises from the provision of investment advice alone. (821 F.2d at 815-17, 12a-16a.) The lower court noted that in *Board of Governors* v. *Investment Co. Institute*, 450 U.S. 46 (1981), the Court had upheld against Glass-Steagall challenge a bank affiliate's provi-

sion of investment advice to a closed-end mutual fund, and reasoned that the hazards that arise when bank affiliates promote the purchase and sale of particular securities therefore were not the sort of hazards which Glass-Steagall was designed to prevent. (821 F.2d at 817, 14a.) The court disagreed that NatWest would have the ability to influence which securities its customers buy and sell, because those customers will still be able to trade securities that NatWest has not recommended. (*Id.* at 818, 17a.) The court also agreed with the Board that most of the dangers presented by this activity are unlikely, or sufficiently minimized, by the various commitments and restrictions imposed by the Board upon NatWest's activity. (*Id.* at 818-19, 17a-18a.)

REASONS FOR GRANTING THE WRIT

I.

THE OPINION BELOW RAISES IMPORTANT ISSUES OF NATIONAL SIGNIFICANCE

The Board's Order, affirmed by the court below, significantly changes the structure of the nation's financial services industry. It marks the first time a bank affiliate has been permitted to become a full-service securities broker since Congress passed the Glass-Steagall Act over fifty years ago.

The Glass-Steagall Act was enacted in June 1933 in the wake of the Great Depression and the near-total collapse of the American financial system, as thousands of bank failures occurred across the country. Congress determined a major cause of the banking crisis to have been commercial bank involvement, often through "security affiliates," in various securities activities. It designed the Act to be a "prophylactic measure directed against conditions that the experiences of the 1920's showed to be great potentials for abuse."[10] Congress

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10 *Investment Co. Institute* v. *Camp*, 401 U.S. 617, 639 (1971) ("*ICI*").

had become convinced "that the role of a bank as a promoter of securities was fundamentally incompatible with its role as a disinterested lender and adviser."[11] Rejecting mere regulation of banks' securities activities, Congress adopted "a broad structural approach" in the Glass-Steagall Act that operates "[t]hrough flat prohibitions" to separate commercial banks from the securities business "as completely as possible." *Bankers Trust*, 468 U.S. at 147.

One of the provisions then enacted spoke directly to bank affiliation with securities entities. That provision, Section 20 of the Glass-Steagall Act, provides that no member bank of the Federal Reserve System may affiliate with any entity engaged principally in the "issue, flotation, underwriting, *public sale*, or distribution" of securities. 12 U.S.C. § 377 (emphasis supplied). From the outset, the Act was understood to bar bank affiliates from promoting securities and/or soliciting trades in them.

Beginning in 1936 and continuing to date, the Board itself has interpreted virtually identical language in Section 32 of the Act to prohibit interlocking managements between banks and brokers other than "[a] broker who is engaged *solely in executing orders* for the purchase and sale of securities on behalf of others in the open market. . . ."[12] This contemporaneous interpretation, which the Court has found to be equally applicable under Section 20 of the Act,[13] shows the Board's understanding that brokers who engage in activities beyond execution services—such as supplying investment advice—were within the Act's prohibitions. Board rulings within the last five years reiterated that a broker who promoted securities through

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11 *Securities Industry Ass'n* v. *Board of Governors*, 468 U.S. 137, 154 (1984) ("*Bankers Trust*").

12 22 Fed. Res. Bull. 51, n.1. Section 32 bars interlocking personnel between banks and securities firms; whereas, Section 20 generally bars corporate affiliations between such entities. 12 U.S.C. §§ 78, 377.

13 *See Schwab*, 468 U.S. at 219.

investment advice was covered by the Act.[14] The banking industry obviously had the same understanding; during the ensuing one-half century after the Act was passed no bank even sought permission to engage through affiliates in full-service brokerage.

Now, without any congressional action and in direct contravention of its own long-standing administrative view, the Board has permitted banks to organize affiliates that would engage in virtually all aspects of the securities business other than underwriting new issues of securities. By its order here at issue, the Board has permitted bank affiliates to promote specific securities to the public; to solicit trades in those and other securities; and ultimately to execute trades in the securities solicited or promoted. Acting in combination with foreign affiliates, the Order in addition allows banking organizations in effect to deal as principals in securities domestically (*see* pp. 13-14, *infra*), clearly a major transformation of the congressional scheme.

The decision below also raises basic questions concerning the role of administrative agencies in setting national policy. By affirming the Board, the court effectively sanctioned a contin-

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14 In *United Jersey Banks*, 69 Fed. Res. Bull. 565, 568 (1983), the Board permitted a bank holding company to acquire a discount broker, precisely because that broker would not provide investment advice and accordingly would not have a prohibited salesman's stake in particular securities:

> [B]ecause . . . [the broker] would not deal in securities for its own account and would not actively promote any particular security through the provision of investment advice or otherwise, it would not have the 'salesman's stake' or promotional interest in the success or failure of any particular issue of securities that led Congress to mandate a separation of banking from certain types of securities related activities.

See also Sovran Financial Corp., 72 Fed. Res. Bull. 146 (1986) (permitting a bank holding company to combine its discount brokerage and economic advisory functions in a single entity, where the subsidiary did not provide investment advice concerning the securities traded through its discount brokerage operations).

uing administrative effort to dismantle the Glass-Steagall Act through increasingly far-reaching administrative "interpretations." Absent action by the Court now, the decision here at issue is certain to impel still further administrative rulings weakening the Glass-Steagall bar. Building on its Order and the decision below, the Board has *already* sanctioned bank securities affiliates that not only promote securities as well as execute trades in them, but also exercise investment discretion over securities accounts. *J.P. Morgan & Co.*, Order of the Board of Gov. of the Fed. Res. Sys. (Aug. 5, 1987).

In short, the decision in this case presents fundamental questions of national significance both as to the structure of the financial services industry throughout the country and as to the proper role of administrative agencies in carrying out congressional policy governing that structure. For this reason alone, review by the Court is warranted.

II.

THE OPINION BELOW CONFLICTS WITH PRIOR DECISIONS OF THIS COURT AND RAISES SUBSTANTIAL QUESTIONS OF FEDERAL LAW

The ruling at issue is inconsistent with the prior decisions of the Court construing the remedial provisions of the Glass-Steagall Act. It ignores the Court's direction that the prohibitory terms of the Act are to be literally applied, adopts an open-ended statutory analysis the Court already has rejected, permits hazards the Court has held the Act was designed to prevent, and imposes a regulatory regimen the Court previously has held improper under the flat prohibitions of the Act.

1. The decision below conflicts with the Court's prior directions concerning construction of Glass-Steagall terms. The Court has made clear that the terms of the Glass-Steagall Act are to be applied "as they were written," *ICI*, 401 U.S. at 639, and rejected the Board's "departure from the literal meaning of the Act," *Bankers Trust*, 468 U.S. at 152-53. There is no

dispute that the full-service brokerage activities at issue fall within the literal meaning of the term "public sale" in Section 20 of the Glass-Steagall Act. The court of appeals conceded just that. (821 F.2d at 815, 11a.)

Even so, the court concluded that the term "public sale" covered only activities undertaken on behalf of issuers. (821 F.2d at 814, 8a-9a.) The court based this conclusion on the statement in *Schwab* that the words "public sale" should be read in light of the activity connoted by terms surrounding it (*e.g.*, "underwriting" and "distribution"). (821 F.2d at 813, 7a (citing 468 U.S. at 216).) Because, in its view, the "critical attributes of underwriters" comprise "either purchas[ing] securities from the issuer or act[ing] as the agent of the issuer," and because CSC claims not to engage in activities on behalf of issuers, the court below concluded that CSC would not be engaged in the "public sale" of securities prohibited by Section 20. (*Id.* at 814-15, 9a-11a.)

The court's rationale actually contravenes the teaching of *Schwab*, upon which it purports to rely. By restricting the reach of "public sale" solely to activities on behalf of issuers, the logic of the court below would limit application of Section 20 solely to the primary (new issue) market and exclude the secondary (trading) market for securities. Yet the Court in *Schwab* drew no such distinction; to the contrary, the Court expressly noted (468 U.S. at 219, n.20) that Section 20 prohibits bank affiliates from "dealing" in securities—commonly understood to be a *secondary* market activity. The logic of the court below equally conflicts with that of the Board itself, which for over 50 years has construed the term "public sale" in Section 20 to cover securities dealing in the secondary market, an interpretation the Board reiterated in detail as recently as this past April. *Citicorp*, 73 Fed. Res. Bull. 473, 481, 506-08 (1987), *app. pending*, No. 87-4041 (2d Cir. filed May 1, 1987).

The court's rationale limiting the term "public sale" also all but ignored what this Court had said in *Bankers Trust* about the congressional purpose underlying the Glass-Steagall Act.

As the Court explained there, Congress separated banks from the securities business because it found "the role of a bank as a promoter of securities [is] fundamentally incompatible with its role as a disinterested lender and adviser." 468 U.S. at 154. "[G]iving banks a pecuniary incentive in the marketing of a particular security," the Court said, "seems to produce precisely the conflict of interest that Congress found would impair a commercial bank's ability to act as a source of disinterested financial advice." *Id.* at 156.

A promotional incentive, or "saleman's interest" (*ICI*, 401 U.S. at 631), is a common attribute of *all* the terms in Section 20. Given the congressional purpose underlying the Glass-Steagall Act, as detailed in *Bankers Trust*, the existence of a promotional incentive—not some relationship with an issuer—*should* have been determinative in construing "public sale" consistently with the terms surrounding it. Just such an incentive inheres in full-service brokerage, which involves promotion and/or solicitation of trades in specific securities. And, indeed, the Court in *Schwab* took pains to point out that the so-called "discount" brokerage it found in that case to be outside Section 20 involved *no* such investment advice.[15] In short, to avoid the literal meaning of "public sale" in Section 20, the decision below misconstrued the Court's analysis of statutory language in *Schwab* and disregarded the Court's instruction in *Bankers Trust* as to Congress' Glass-Steagall objective.

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15 The Court repeatedly restricted its discussion in *Schwab* solely to "the *type* of retail brokerage business" at issue in the case. 468 U.S. at 218. The "discount" broker there involved was one that "does *not* provide investment advice or analysis, but merely executes the purchase and sell orders placed by its customers." *Id.* at 209, n.2 (emphasis supplied). The Court upheld the Board's determination only that " 'the business of purchasing or selling securities upon the *unsolicited* order of, and as agent for, a particular customer does not constitute the "public sale" of securities for purposes of Section 20.' " *Id.* at 221 (emphasis supplied). And, the Court expressly limited its holding in *Schwab* to "a securities brokerage business that is essentially limited to the purchase and sale of securities for the account of customers, and *without provision of investment advice* to purchaser or seller. . . ." *Id.* (emphasis supplied).

2. The decision below adopts an approach to Glass-Steagall analysis flatly rejected by the Court in *ICI*. The decision permits NatWest's activity because none of the components of that activity, if conducted separately, would be prohibited under the Glass-Steagall Act. (821 F.2d at 814, 8a-10a.) Similarly, in *ICI* the Comptroller of the Currency had approved a bank's operation of an open-end investment company, based upon its analysis that each of the component activities involved was separately permitted under the Glass-Steagall Act. 401 U.S. at 624. Rejecting that analysis, the Court held:

> No provision of the banking law suggests that it is improper for a national bank to pool trust assets, or to act as a managing agent for individual customers, or to purchase stock for the account of its customers. *But the union of these powers gives birth to an [entity] whose activities are of a different character.*

Id. at 624-25 (emphasis supplied). Here, too, the combination of investment advisory with securities execution services creates a new entity, a full-service broker, the combined activities of which do create Glass-Steagall concerns.

Actually, if the analysis of the decision below were correct, bank affiliates *arguendo* could undertake any number of activities that unquestionably are impermissible under the Act. "Underwriting" for example, may encompass buying securities for one's own account, holding them and ultimately selling them. Each of these "components" separately may be allowed to banks for "investment securities."[16] Yet, there can be absolutely no doubt that combining them creates an activity—underwriting—clearly prohibited by the Glass-Steagall Act. Again, absent review, the decision below will create continuing confusion as to the Act's proper application.

3. The decision below conflicts with the Court's repeated instructions that the Act is to prohibit securities activities that will cause the hazards the Glass-Steagall Congress sought to

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16 Section 16 of the Glass-Steagall Act permits banks to purchase, for their own account, investment securities. 12 U.S.C. § 24(7).

eliminate. *Bankers Trust*, 468 U.S. at 154-58; *ICI*, 401 U.S. at 630-34. Those hazards, the Court has made clear, include not only bank securities activities with "obvious dangers" such as risking depositors' funds through speculative investments, but also those activities giving rise to "subtle hazards" such as potential conflicts of interest that may impair a bank's impartiality as a lender and financial advisor or cause loss of customer confidence. *ICI*, 401 U.S. at 631. The Court has made equally plain that the Act is concerned with possible, and not just proven, risks. The Act's prohibition "reflects Congress' conclusion that *the mere existence* of a securities operation, 'no matter how carefully and conservatively run, is inconsistent with the best interests' of the bank as a whole." *Bankers Trust*, 468 U.S. at 157 (quoting 75 Cong. Rec. 9913 (1932) (remarks of Sen. Bulkley)) (emphasis added).

The court below, however, affirmed the Board even though the Board had concluded that the activity of CSC, the brokerage entity here, creates the potential for the very "conflicts" and other "hazards" the Court has held the Act was designed to prevent. (72 Fed. Res. Bull. at 594-95, 48a-51a.) Nor do those conflicts result simply from CSC's incentive to promote specific securities in order to reap greater brokerage commissions. The Board's Order permits CSC to promote securities underwritten or held by its U.K. merchant bank affiliate within the NatWest group.[17] When CSC acts as the domestic sales outlet for its overseas banking affiliates (either promoting securities distributed by those affiliates overseas or securities held by the overseas affiliates as dealers) the economic interests of NatWest as a financial entity are not limited to the brokerage commissions paid to CSC. In reality, this scheme is little more than an artifice allowing NatWest, as an integrated entity, to purchase and sell securities for its own account, *i.e.*, deal in securities, within the United States. If CSC is allowed to operate as permitted by the court of appeals, the NatWest group stands to gain or lose NatWest's markup, or spread,

17 72 Fed. Res. Bull. at 590 n.25, 37a, n.25; *see* 821 F.2d at 819 n.9, 18a, n.9.

upon the securities sold through CSC, thus further magnifying the potential for just the sort of "salesman's stake" and conflicts of interest the Act was meant to prohibit.

4. The decision below followed the same kind of regulatory approach to the Glass-Steagall Act that the Court has rejected. The Court has left no doubt the Act requires prohibition, not mere regulation, of the activities it covers. Although that approach was "not without costs in terms of efficiency and competition," Congress determined to enact "a strong prophylaxis." *Bankers Trust*, 468 U.S. at 148.

> Congress rejected the view of those who preferred legislation that simply would regulate the underwriting activities of commercial banks. Congress chose instead a broad structural approach [of] . . . flat prohibitions.

Id. at 147. Underscoring "Congress' refusal to give the Board any rulemaking authority over the activities prohibited by the Act," *id.* at 154, the Court has reiterated in no uncertain terms that "*Congress rejected a regulatory approach when it drafted the statute, and it has adhered to that rejection ever since*," *id.* at 153 (emphasis supplied). In short, the Court has made clear that mere regulation of activities having, as here, the potential to raise Glass-Steagall concerns is an option precluded by Congress.

Despite these unambiguous admonitions, and its own recognition that CSC's full-service brokerage operations could give rise to Glass-Steagall hazards, the Board did not prohibit the activities. Instead, it extracted a legion of "commitments" from NatWest during the administrative process; imposed still further "conditions" on CSC's activities;[18] and then simply brushed aside the admitted risks as not "likely," not "significant," or sufficiently "minimize[d]." (72 Fed. Res. Bull. at 590, 595, 37a, 51a.)

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18 The "commitments" required by the Board, which were in addition to those NatWest proposed in its own application, are described at 821 F.2d at 812 & n.4, 5a & n.4.

The sort of "conditions" and "commitments" cited by the Board are unmistakable earmarks of a regulatory regime; they are not self-executing and will obviously require ongoing regulatory supervision. Thus, by its ruling here, the Board again "effectively convert[ed] a portion of the Act's broad prohibition into a system of administrative regulation"—in direct conflict with the Court's directions. *Bankers Trust*, 468 U.S. at 153. As the Court put it in nullifying the Board's similar analysis in *Bankers Trust*, administrative guidelines (here "conditions") "may be a sufficient regulatory approach to the potential problems," but such an approach is impermissible under the Glass-Steagall Act. *Id.*

CONCLUSION

The decision below conflicts with the Court's prior decisions concerning the scope of the Glass-Steagall Act and raises issues of national significance directly affecting the entire financial services industry. Further action by the Court is essential to resolve fundamental issues concerning both the scope of activities permitted to banks under federal law and the manner in which regulation of financial institutions is to be conducted. A writ of *certiorari* should issue to review this decision.

Dated: October 2, 1987

Respectfully submitted,

Of Counsel:

William J. Fitzpatrick
Securities Industry
Association
120 Broadway
New York, New York 10271

Donald J. Crawford
Securities Industry
Association
1850 M Street, N.W.
Washington, D.C. 20036

James B. Weidner
(*Counsel of Record*)
David A. Schulz
Mark Holland
ROGERS & WELLS
200 Park Avenue
New York, New York 10166
(212) 878-8000
Attorneys for Petitioner
Securities Industry
Association

APPENDICES

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 86-1412

SECURITIES INDUSTRY ASSOCIATION, PETITIONER

v.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, et al., RESPONDENTS

NATIONAL WESTMINSTER BANK PLC and NATWEST HOLDINGS INC., INTERVENOR

Petition for Review of an Order of the
Board of Governors of the Federal Reserve System

Argued March 13, 1987
Decided July 7, 1987

James B. Weidner, with whom *David A. Schulz* and *William J. Fitzpatrick* were on the brief for petitioner.

Richard M. Ashton, Attorney, Board of Governors of the Federal Reserve System, with whom *Richard K. Willard*, Assistant Attorney General, Department of Justice and *Kevin J. Handly*, Attorney, Board of Governors of the Federal Reserve System were on the brief for respondents.

Richard F. Ziegler for intervenor.

John J. Gill, III and *Michael F. Crotty* were on the brief for *amicus curiae*, American Bankers Association, urging affirmance of the Board of Governors' decision.

J. Michael Luttig was on the brief for *amicus curiae*, New York Clearing House Association, urging affirmance of the Board of Governors' decision.

Before:

BORK and SILBERMAN, *Circuit Judges*,
and MARKEY,* *Chief Judge*.

Opinion for the Court filed by *Circuit Judge* BORK.

BORK, *Circuit Judge*: Section 20 of the Glass-Steagall Act[1] prohibits the affiliation of member banks of the Federal Reserve System with corporations "engaged principally in the

* Of the United States Court of Appeals for the Federal Circuit, sitting by designation pursuant to 28 U.S.C. § 291(a) (1982).

1 The Glass-Steagall Act is the popular name for four provisions in the Banking Act of 1933. *See* 12 U.S.C. §§ 24 (Seventh), 78, 377, 378 (1982 & Supp. III 1985). The provisions were enacted in the wake of the 1929 stock market crash with the "general purpose of separating as completely as possible commercial from investment banking." Board of Governors of the Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46, 70 (1981). Section 16 of the Act prohibits commercial banks from purchasing or selling securities except "upon the order, and for the account of, customers." 12 U.S.C. § 24 (Seventh) (1982 & Supp. III 1985). Section 20 prohibits member bank affiliation with corporations engaged principally in certain securities activities. *Id.* § 377 (1982). Section 21 bars "any person, firm, corporation, association, business trust, or other similar organization" from engaging in securities activities while engaged in "the business of receiving deposits." *Id.* § 378 (1982). Finally, § 32 prohibits corporate interlocks between member banks and entities "primarily engaged" in the securities activities listed in § 20. *Id.* § 78 (1982).

issue, flotation, underwriting, public sale, or distribution" of securities. 12 U.S.C. § 377 (1982). The issue here is whether the Board of Governors of the Federal Reserve System reasonably concluded that the combined provision of securities brokerage services and investment advice by a member bank's affiliate does not implicate section 20's prohibition of the "public sale" of securities. We find that the Board's decision is a reasonable interpretation of the language and legislative history of the Act and is consistent with prior precedent. We therefore deny the petition for review.

I.

In August 1985, National Westminster Bank PLC and its subsidiary NatWest Holdings, Inc. (collectively "NatWest") submitted an application to the Board pursuant to section 4(c)(8) of the Bank Holding Company Act of 1956, as amended, 12 U.S.C. § 1843(c)(8) (1982),[2] for permission to provide investment advice and securities brokerage services to institutional customers through a newly formed subsidiary, County Securities Corporation ("CSC").[3]

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2 Section 4(c)(8) is an exception to the general prohibition in the Bank Holding Company Act of acquisition by a bank holding company of ownership or control of a company that is not a bank. *See* 12 U.S.C. § 1843(a) (1982). Section 4(c)(8) authorizes a bank holding company to acquire "shares of any company the activities of which the Board after due notice and opportunity for hearing has determined (by order or regulation) to be so closely related to banking or managing or controlling banks as to be a proper incident thereto." *Id.* § 1843(c)(8). In determining whether an activity is a "proper incident," the Board is to "consider whether its performance by an affiliate of a holding company can reasonably be expected to provide benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices." *Id.*

3 Specifically, NatWest sought approval for CSC to engage in the following activities:

> (1) provide "portfolio investment advice to Institutional Customers," a term defined to include a bank, insurance company or corporation

As proposed by NatWest, CSC's brokerage services would be restricted to buying and selling securities solely as agent for the account of customers. CSC would execute transactions only at the request of its customers and would not exercise any discretion with respect to a customer's account. Joint Appendix ("J.A.") at 63. CSC would not act as principal or as underwriter and would not bear any financial risk with respect to any security it brokers or recommends. *Id.* at 102. Generally, CSC would receive all of its compensation, including that for investment advice, in the fees for securities transactions it executes for customers. *Id.* at 10-11. CSC would charge separate fees for investment advice and brokerage services upon request of a customer. *Id.* at 11.

NatWest's application also provided that CSC would hold itself out as a corporate entity separate and distinct from NatWest and would have its own assets, liabilities, books and

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"with assets exceeding $5,000,000 that regularly invests in the types of securities as to which investment advice is given, or that regularly engages in transactions in securities; . . . an employee benefit plan with assets exceeding $5,000,000 . . . ; and a natural person whose individual net worth . . . at the time of receipt of the investment advice or brokerage services exceeds $5,000,000." [Joint Appendix ("J.A.") at 10-11];

(2) provide "securities brokerage services, related securities credit activities pursuant to the Board's Regulation T, and incidental activities such as offering custodial services and cash management services, in each case for Institutional Customers, and in each case under circumstances where the securities brokerage services are restricted to buying and selling securities solely as agent for the account of such Customers;"

(3) furnish "general economic information and advice, general economic statistical forecasting services and industry studies to Institutional Customers; and"

(4) serve "as investment advisor (as defined in Section 2(a)(20) of the Investment Company Act of 1940) to investment companies registered under that Act."

J.A. at 63.

records. J.A. at 12. NatWest and CSC would not share customer or depositor lists or confidential information. *Id.*[4]

In an order dated June 13, 1986, the Board approved the application. *National Westminster Bank PLC*, 72 Fed. Res.

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4 While the application was pending, the Board sought and received further commitments from NatWest regarding its relationship with CSC and regarding CSC's proposed activities:

> "1. The Subsidiary will not transmit its investment advisory research or recommendations to the commercial lending department of any member of the NatWest group. (This is not intended, of course, to preclude the publication or dissemination of the Subsidiary's research or recommendations to potential Institutional Customers (as defined in the Application) generally.)" J.A. at 173.
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> "2. In any brokerage transaction performed by the Subsidiary where the counterparty (as principal) is a member of the NatWest group, NatWest will disclose this fact to the brokerage customer and obtain specific consent from the customer for such transaction." *Id.*
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> 3. "No director of the Subsidiary will also be a director of either NatWest PLC, National Westminster Bank USA, N.A. ("*NatWest* USA") or any subsidiary of NatWest USA. It is anticipated, however, that certain directors of the Subsidiary may also be directors of other subsidiaries of NatWest PLC." J.A. at 175.
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> 4. "No officer of the Subsidiary will also serve as an officer of either NatWest PLC, NatWest USA or any subsidiary of NatWest USA. In addition, no officer of the Subsidiary engaged in providing investment advisory or securities brokerage services will also provide such services for, on behalf of or with respect to any other member of the NatWest group. As noted in the Application (at 9), the Subsidiary will be maintained, and will hold itself out to the public, as a separate and distinct corporate entity, and will conduct its business separate from the other members of the NatWest group." *Id.*
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> 5. "The Subsidiary will not refer its customers who desire to purchase securities on credit to any Affiliate." J.A. at 177.
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> 6. "There will be no established program by which an Affiliate will extend credit for securities purchases to the Subsidiary's customers." *Id.*
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> 7. "As set forth in the Application (at 60), the Subsidiary is seeking approval to engage in securities credit activities pursuant to the Board's Regulation T and, accordingly, is expected to have its own margin account/lending ability, with normal associated powers." *Id.*

Bull. 584 (1986). The Board determined first that CSC's proposed activities are closely related to banking and that the proposal may reasonably be expected to result in public benefits that outweigh possible adverse effects so that the activities are a "proper incident" to banking within the meaning of section 4(c)(8) of the Bank Holding Company Act. *Id.* at 584-91. The Board then concluded that NatWest's acquisition of CSC would not violate the Glass-Steagall Act because the combination of investment advice and execution services does "not constitute a 'public sale' of securities for purposes of sections 20 and 32 of the . . . Act." *Id.* at 592.[5] The Securities Industry Association ("SIA"), a trade association of underwriters, brokers and securities dealers, then petitioned for review of the Board's decision. SIA challenges only the Board's determination that provision of the proposed services would not violate section 20 of the Glass-Steagall Act.

II.

Because the Board engaged in a comprehensive review of the language and legislative history of section 20, and provided a detailed and reasoned explanation for its conclusion that the

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5 Those non-bank activities found by the Board to be "closely related to banking" and thus permissible activities for bank holding companies are listed in the Board's Regulation Y. 12 C.F.R. § 225 (1986). At the time of NatWest's application, Regulation Y provided that a bank holding company could permissibly act as an investment advisor, as defined in § 20(a)(20) of the Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(20) (1982), to an investment company registered under that Act. 12 C.F.R. § 225.25(b)(4)(ii) (1986.) This provision was upheld by the Supreme Court in Board of Governors of the Fed. Reserve Sys. v. Investment Co. Inst., 450 U.S. 46 (1981) ("*ICI*"). This provision also permits bank holding companies to provide portfolio investment advice to any other person. 12 C.F.R. § 225.25(b)(4)(iii) (1986). Regulation Y also provided at the time of NatWest's application that bank holding companies could provide securities brokerage services, if the services were "restricted to buying and selling securities solely as agent for the account of customers and do not include securities underwriting or dealing or investment advice or research services." *Id.* § 225.25(15) (1986). These activities were upheld against Glass-Steagall Act challenges in Securities Indus. Ass'n v. Board of Governors of the Fed. Reserve Sys., 468 U.S. 207 (1984) ("*Schwab*").

proposed activities do not fall within that provision's prohibitions, its decision is entitled to "substantial deference." *Securities Indus. Ass'n* v. *Board of Governors of the Fed. Reserve Sys.*, 807 F.2d 1052, 1056 (D.C. Cir. 1986) ("*Bankers Trust II*"), *cert. denied*, 55 U.S.L.W. 3853 (June 23, 1987); *see Securities Indus. Ass'n* v. *Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207, 217 (1984); *Board of Governors of the Fed. Reserve Sys.* v. *Investment Co. Inst.*, 450 U.S. 46, 56 (1981). Since Congress has not addressed the issue of whether the combined provision of brokerage services and investment advice is a "public sale" within the meaning of section 20, we must uphold the Board's interpretation if it is a reasonable construction of the statute. *INS* v. *Cardoza-Fonseca*, 107 S. Ct. 1207, 1221-22 (1987); *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-45 (1984); *Investment Co. Inst.* v. *Conover*, 790 F.2d 925, 932 (D.C. Cir. 1986), *cert. denied*, 107 S. Ct. 421-22 (1986).

In determining the meaning of section 20 of the Act, which prohibits member bank affiliation with any corporation "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities, we are not without guidance. In *Securities Indus. Ass'n* v. *Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 207 (1984) ("*Schwab*"), the Supreme Court addressed the issue of whether the provision of "discount" brokerage services—the provision of execution services without investment advice—violated section 20 and concluded that the term "public sale" must be read in conjunction with the terms surrounding it. The Court then held that discount brokerage did not fall within the term "public sale":

> None of the [ ] terms [in section 20] has any relevance to the brokerage business at issue in this case. Schwab does not engage in issuing or floating the sale of securities, and the terms "underwriting" and "distribution" traditionally apply to a function distinctly different from that of a securities broker. An underwriter normally acts as principal whereas a broker executes orders for the purchase or sale of securities solely as agent.

468 U.S. at 217-18 (footnotes omitted). The Court thus upheld the Board's determination that "the business of purchasing or selling securities upon the unsolicited order of, and as agent for, a particular customer does not constitute the 'public sale' of securities for purposes of section 20," *id.* at 221 (internal quotation omitted). The Court did not reach the question presented in this petition of whether the combined provision of brokerage services and investment advice is the "public sale" of securities.

The Court has, however, addressed the question of whether the independent provision of investment advice violates the prohibitions in the Act. In *Board of Governors of the Fed. Reserve Sys.* v. *Investment Co. Inst.*, 450 U.S. 46 (1981) ("*ICI*"), the Court held that "[t]he management of a customer's investment portfolio—even when the manager has the power to sell securities owned by the customer—is not the kind of selling activity Congress contemplated when it enacted § 21," *id.* at 63, because when the advisor acts in this situation it is "for the account of its customer—not for its own account." *Id.* at 66 n.37.[6]

Thus, because the Court has upheld against Glass-Steagall challenges the independent provision of CSC's proposed services, the only issue presented here is whether the combined provision of investment advice and securities brokerage services tranforms these separately permissible activities into a "public sale" within the meaning of section 20. The Board concluded that they did not because

> [i]n providing investment advice in connection with the execution of securities transactions, CSC would act solely as agent for its customers and would not act as a principal (*i.e.*, with its own funds) in buying and selling securities.

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6 There is no reason to believe that the Court's holding with respect to § 21, which prohibits any entity "engaged in the business of . . . selling" securities from receiving deposits, would not be equally applicable to the "public sale" provision in § 20. In fact, the Supreme Court has specifically noted that "a less stringent standard should apply to determine whether a holding company has violated section 20 than is applied to a determination of whether a bank has violated sections 16 and 21." *ICI*, 450 U.S. at 61 n.26.

> CSC would not, like many securities firms, make a market in securities with its own funds. Nor would CSC offer securities to the public as agent for the issuer of securities.

72 Fed. Res. Bull. at 592 (footnote omitted). We believe that this is a reasonable interpretation of the term "public sale" as defined by the Court in *Schwab*. The addition of investment advice to brokerage activities does not implicate any of the activities which the *Schwab* Court described as traditionally associated with underwriting.

As was the case in *Schwab*, CSC will have no relationship with the issuer other than that related to the execution of transactions as agent for the customer. CSC will not purchase the issuer's securitites for sale to the public, *see Schwab*, 468 U.S. at 217-18 n.17, but instead will "execute[ ] orders for the purchase or sale of securities solely as agent." *See id.* at 218. Nor will CSC act as agent for the issuer as a "best efforts" underwriter. *See id.* at 217-18 n.17.[7] The proposed activities in this case, for purposes of determining the scope of the term "public sale," are simply indistinguishable from the activities described in *Schwab*.

The sole distinction cited by SIA is that CSC will also provide investment advice. We cannot understand, however, why this should transform the proposed activities into the public sale of securities. *See Bankers Trust II*, 807 F.2d at 1061 (rejecting contention that rendering financial advice itself removes a bank's placement activities from the category of transactions made "solely upon the order of a customer"). While it is true that the provision of investment advice may be another attribute common to underwriters, this does not necessarily mean that it transforms the activities into those of underwriters. The critical attributes of underwiters, as defined in *Schwab*, are that they either purchase securities from the issuer or act as the agent of the issuer. 468 U.S. at 217-18. The

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7 The Court in *Schwab* expressly declined to address the issue of whether best efforts underwriting by an affiliate would violate the Act. *See* 468 U.S. at 217-18 n.17. We do not decide that issue here.

provision of investment advice does not alter the fact that CSC will not engage in either of these activities.

This interpretation of the Act is also consistent with the Court's decision in *ICI*. The Court there specifically held that the provision of investment advice by a non-bank subsidiary, even when coupled with the power to sell the securities owned by the customer, was not "selling" within the meaning of section 21. 450 U.S. at 63. The Court based its decision in part on the finding that Congress could not have intended in section 21 to require banks to abandon the traditional practice of managing investment accounts in a fiduciary capacity or as an agent for an individual. *Id.* The Court described these practices earlier in the opinion as follows:

> The services of an investment adviser are not significantly different from the traditional fiduciary functions of banks. The princpal activity of an investment adviser is to manage the investment portfolio of its advisee—to invest and reinvest the funds of the client. Banks have engaged in that sort of activity for decades. As executor, trustee, or managing agent of funds committed to its custody, a bank regularly buys and sells securities for its customers. Bank trust departments manage employee benefits trusts, institutional and corporate agency accounts, and personal trust and agency accounts.

Id. at 55; *see also Schwab*, 468 U.S. at 212 n.8 ("banks often execute purchase and sell orders for securities that are not traded on an exchange without an intervening broker. To this extent they perform the same services as a retail broker"). The activities described by the Court in *ICI* are similar to those proposed by CSC. In each case the bank, or bank affiliate, offers investment advice and provides for the execution of the purchase or sale of securities for the customer. One difference between the services proposed here and those addressed by the Court in *ICI* is that the bank in *ICI* also had discretionary authority with respect to the customer's account and CSC will be permitted to execute a transaction only upon the request of

a customer. This distinction, of course, cuts against the argument that CSC's services are a "public sale." The discretionary authority of the bank in *ICI* rendered it arguably more like a principal than the mere agent of a customer.

The second distinction, which was raised by SIA during oral argument, is that the bank in *ICI* rendered advice only to its existing customers whereas CSC will provide services for any "Institutional Customer." *See supra* note 3. SIA argues that this distinction renders CSC's proposed services a "public sale" because it will place CSC in a better position to manipulate the market through the purchase and sale of securities. This conclusion does not follow from its premise. A bank with existing large institutional customers, and with discretionary management authority over the customer's accounts, would seem to be in a better position than CSC to affect the market through the purchase or sale of securities.

SIA has not raised a serious challenge to the Board's finding that CSC's proposed activities do not fall within the literal meaning of "public sale" as interpreted by the Court in *Schwab*. SIA relies primarily on the definition of "sale" in the *American Heritage Dictionary* (1970 ed.), which includes to "promote," for its argument that the provision of investment advice transforms the brokerage services into a sale. *See* Reply Brief for Petitioner Securities Industry Association at 1-2 & n.2. While a dictionary definition may be useful for a number of purposes, it cannot override a more specific meaning given by the statutory context in which a word resides. The Supreme Court in *Schwab* held that the term "public sale" must be read in conjunction with the underwriting activities surrounding it in the Act and the definition so derived is the one the Board is bound to apply.

III.

SIA's primary challenge to the Board's order is that CSC's proposed activities implicate the "subtle hazards" that led Congress to pass the Act and thus must be deemed to be

included in the term "public sale." We find, however, that the legislative history, from which the Supreme Court has gleaned these "subtle hazards," confirms the Board's interpretation of section 20.

In *Investment Co. Institute* v. *Camp*, 401 U.S. 617 (1971), the Supreme Court held that the operation by a bank of a mutual fund which was the equivalent of an open-end investment company was prohibited by the language of sections 16 and 21 of the Act. *Id.* at 625, 639. The Court went on, however, to address the legislative history and the policies underlying the Act and concluded that "[t]he hazards that Congress had in mind were not limited to the obvious danger that a bank might invest its own assets in frozen or otherwise imprudent stock or security investments." *Id.* at 630. The Court found that "Congress also had in mind and repeatedly focused on the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business either directly or by establishing an affiliate to hold and sell particular investments." *Id.*

As later summarized by the Court, the subtle hazards identified in *Camp* were these:

> The Court recognized that because the bank and its affiliate would be closely associated in the public mind, public confidence in the bank might be impaired if the affiliate performed poorly. Further, depositors of the bank might lose money on investments purchased in reliance on the relationship between the bank and its affiliate. The pressure on banks to prevent this loss of public confidence could induce the bank to make unsound loans to the affiliate or to companies in whose stock the affiliate has invested. Moreover, the association between the commercial and investment bank could result in the commercial bank's reputation for prudence and restraint being attributed, without justification, to an enterprise selling stocks and securities. Furthermore, promotional

> considerations might induce banks to make loans to customers to be used for the purchase of stocks and might impair the ability of the commercial banker to render disinterested advice.

ICI, 450 U.S. at 66-67 n.38.

In *Schwab*, also decided after *Camp*, the Court again addressed the legislative history of the Act and concluded "that Congress enacted § 20 to prohibit the affiliation of commercial banks with entities that were engaged principally in 'activities such as underwriting.' " 468 U.S. at 219, *quoting ICI*, 450 U.S. at 64. The Court reaffirmed the finding in *Camp* that "[c]ongressional concern over the underwriting activities of bank affiliates included both the fear that bank funds would be lost in speculative investments and the suspicion that the more 'subtle hazards' associated with underwriting would encourage unsound banking practices," 468 U.S. at 220, but the opinion limited this finding by concluding that "all" of the "subtle hazards" identified by Congress "are attributable to the promotional pressures that arise from affiliation with entities that purchase and sell investments on their own account." *Id.* at 220 n.23.

The Court then held that the provision of discount brokerage services does not implicate any of the "subtle hazards" identified by Congress:

> Because Schwab trades only as agent, its assets are not subject to the vagaries of the securities markets. Moreover, Schwab's profits depend solely on the volume of shares it trades and not on the purchase or sale of particular securities. Thus, [the bank] has no "salesman's stake" in the securities Schwab trades. It cannot increase Schwab's profitability by having its bank affiliate extend credit to issuers of particular securities, nor by encouraging the bank affiliate improperly to favor particular securities in the management of depositors' assets.

468 U.S. at 220-21.

As an initial matter, we do not believe that any discussion of "subtle hazards" is necessary here because it is clear that CSC will not "hold and sell particular investments," *see Camp*, 401 U.S. at 630, or "purchase and sell [securities] on [its] own account," *see Schwab*, 468 U.S. at 220 n.23—the circumstances the Supreme Court has stated give rise to these "subtle hazards."[8] Further, each of the negative findings in *Schwab* is equally applicable to CSC's proposed services. CSC will not invest its own funds, or those of NatWest, but will act only as agent for the customer. Because CSC will receive a commission only on transactions it executes, regardless of whether CSC advised the customer to purchase the security or whether the customer followed that advice, its profits will depend "solely on the volume of shares it trades and not on the sale of particular securities." Therefore, because CSC has no interest in the sale of a particular security, NatWest has no "salesman's stake" in the particular security and the "subtle hazards" identified in *Camp* are not implicated.

SIA argues that NatWest will have a "salesman's stake" in the securities CSC may advise its customers to purchase because "CSC will actively promote trades in specific securities and will generate profits based upon its success in convincing customers to purchase or sell those particular securities [:] [w]hen CSC recommends and sells a particular security, CSC acquires an interest in the performance of that security and derivatively, in the financial condition of the issuer." Brief for Petitioner Securities Industry Association at 12-13.

As an initial matter, we do not understand the reasoning underlying SIA's "subtle hazards" analysis. CSC will not have any financial interest in the sale of a particular security. CSC will have no relationship with any issuer and will receive a commission on any sale or purchase it executes for a customer. If CSC advises a customer to buy Company X's securities but

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8 We also question, as we did recently in *Bankers Trust II*, whether any "subtle hazards" analysis is required upon a finding that the challenged activities do not fall within the literal terms of the Act. *See* 807 F.2d at 1066-67.

the customer would prefer to buy Company Z's securities, then CSC clearly would not have an incentive to sell Company X's securities. CSC would be indifferent because it would receive its brokerage fee either way. Thus, CSC's financial incentive relates solely to the *number* of shares it trades and not to any particular security. Further, as noted by NatWest, since CSC will in reality recommend only a small percentage of securities traded, "CSC can hope to operate profitably only if the vast majority of transactions that it brokers involve securities as to which it has made no investment recommendation at all." Brief for Intervenors-Respondents National Westminster Bank PLC and NatWest Holdings, Inc. at 5. Thus, SIA's argument that CSC will have the ability "to influence in *which* securities the customers will trade, with a prospect of increased income as a result," Reply Brief for Petitioner Securities Industry Association at 6, is incorrect.

Although we believe that the decision in *Schwab* is dispositive with respect to the nonexistence of any "subtle hazards" arising from CSC's proposed services, we also find that SIA has not identified any "subtle hazard" which would require the Board to reject NatWest's application. Most of the alleged hazards raised by SIA have been addressed by the Supreme Court and rejected as not within the category of activity Congress sought to prohibit under the Act in the absence of an interest in a particular security.

SIA argues that NatWest might make unsound loans to issuers of securities CSC recommends, that CSC might recommend securities issued by bank customers who have or seek loans from the bank, and that NatWest may lose its reputation for "prudence and restraint" if a depositor follows CSC's advice and the security performs poorly. *See* Brief for Petitioner Securities Industry Association at 12-13. These same potential hazards might flow from the provision of investment advice, which was nonetheless upheld by the Court in *ICI*. We cannot determine how the CSC's provision of execution services will add to the potential for these hazards, and thus we remain bound by the Court's analysis in *ICI*. A contrary holding, that the potential for these hazards is sufficient to

render an activity unlawful, would render all investment advisory activities, including those traditionally performed by bank trust departments, unlawful. We agree with the Court's reasoning in *ICI*, and conclude that Congress could not have intended to render unlawful a significant part of a bank's fiduciary activities through section 20 of the Act. *See ICI*, 450 U.S. at 63; *see also Investment Co. Inst.* v. *Conover*, 790 F.2d at 931.

We also believe that the Board's conclusion that these hazards are not likely to develop given the realities of the brokerage industry and the commitments made by NatWest is entitled to substantial deference. *See Bankers Trust II*, 807 F.2d at 1067 (Board is not foreclosed from "deciding that the realities of a situation make even the potential for conflict substantially unlikely").

The Board found "no significant potential for loss of confidence in an affiliate bank as a result of [the] proposal, given the strict operational separation proposed, . . . the fact that the public and bank depositors should understand that CSC would not commit its funds to any specific investments, and that depositor lists would not be transmitted from an affiliated bank to CSC." 72 Fed. Res. Bull. at 595. The Board also noted that the potential for loss of depositor confidence exists whenever a bank gives investment advice. *Id.* at 589.

The Board also found that there was no "significant potential" that CSC would recommend particular securities of customers so that the proceeds could be used to pay existing loans because CSC's advice will most likely relate to securities traded in the secondary market and federal securities laws require disclosure of the intended use of the proceeds from newly issued securities and because NatWest will not disclose information to CSC regarding loans to customers. 72 Fed. Res. Bull. at 590, 595.

Finally, the Board did not find that there was any significant possibility that NatWest would extend unsound loans to issuers whose securities CSC had recommended because "the expected benefit of such conduct would likely be outweighed by the

potential losses resulting from the bad loans, and . . . information relating to the particular recommendations made by CSC would not be provided to NatWest affiliates." 72 Fed. Res. Bull. at 595.

SIA does not challenge the substance of these reasoned determinations but instead argues that the Board's analysis is flawed because it cannot rely on any of the commitments made by NatWest in its "subtle hazards" analysis. SIA argues that if the Board recognizes any potential hazard, the activity must be prohibited without regard to any arrangement which would prevent its occurrence. By relying on these commitments, SIA argues, the Board again engaged in the practice rejected by the Supreme Court in *Securities Indus. Ass'n* v. *Board of Governors of the Fed. Reserve Sys.*, 468 U.S. 137 (1984) (*"Bankers Trust I"*), of " 'effectively convert[ing] a portion of the Act's broad prohibition into a system of administrative regulation.' " Brief for Petitioner Securities Industry Association at 19, *quoting Bankers Trust I*, 468 U.S. at 153.

We recently rejected this flawed interpretation of *Bankers Trust I*. In *Bankers Trust II*, we held that although "[t]he Glass-Steagall Act does impose a system of flat 'prohibitions' and 'prophylactic' measures, . . . this cannot obviate the need to examine particular factual situations to determine on which side of the prohibitory line they fall." 807 F.2d at 1067. Here, the Board has not attempted to save by continuing regulatory oversight a proposed activity that falls within the literal language of the statute. *See Bankers Trust I*, 468 U.S. at 153. Instead, the Board has reviewed the "realities of a situation," *Bankers Trust II*, 807 F.2d at 1067, has determined that the activities do not fall within the literal language of the statute, and has "impos[ed] restrictions designed to assure that the activity is insulated from that associated with investment banking." 72 Fed. Res. Bull. at 595 (footnote omitted). This practice has been approved by the Supreme Court, *see ICI*, 450 U.S. at 66-67 ("none of these 'more subtle hazards' would be present were a bank to act as an investment adviser . . .

subject to the restrictions imposed by the Board"), and we will not disturb it here.[9]

IV.

Finally, SIA argues that the Board's approval of NatWest's application is inconsistent with its recent decisions in *Sovran*

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9 SIA argues that the "subtle hazards" underlying the Act are implicated because CSC may recommend securities originally underwritten or distributed by County Bank Limited, NatWest's overseas merchant bank affiliate. *See* Brief for Petitioner Securities Industry Association at 13. NatWest's merchant bank affiliate does not engage in securities activities in the United States but is permitted pursuant to the Board's Regulation K, 12 C.F.R. § 211.5(d)(13) (1986), *see* 12 U.S.C. § 1843(c)(9), (c)(13) (1982), to engage in securities dealing and underwriting activities overseas. SIA did not raise this issue before the Board as a potential subtle hazard for purposes of the Glass-Steagall Act. The Board did address this issue in its analysis under the Bank Holding Company Act and concluded that any adverse effect from NatWest's merchant banking activities was not likely to occur:

> The Board notes that NatWest engages in extensive merchant banking activites outside of the United States, including acting as a dealer in securities. However, NatWest has committed that the securities operations of its overseas affiliates will be limited to transactions that do not constitute dealing in securities in the United States. Moreover, in any transaction by CSC in which a NatWest affiliate is a counter-party (*e.g.*, where CSC would purchase securities desired by a customer from its affiliate's inventory), NatWest has committed that CSC will disclose that fact to its customer and obtain the customer's specific consent for the transaction.

72 Fed. Res. Bull. at 590 & n.25. We agree with the Board in its brief on appeal that this "potential hazard" has also been precluded as a basis for rejection of NatWest's application by the Court's analysis in *ICI*; this risk exists whenever a bank holding company with an overseas merchant bank affiliate renders investment advice. Additionally, we do not see how CSC's provision of investment advice and brokerage execution services with respect to the merchant bank's securities could lead to the conclusion that CSC is engaged in the "public sale" of securities in the United States. Petitioner's real challenge is to the Board's determination in Regulation K that banks may be affiliated with an entity that engages in the sale of securities outside the United States; under SIA's theory, NatWest's affiliation with the overseas merchant bank would itself be a violation of § 20. The validity of Regulation K, however, is not an issue that is before us in this case.

Financial Corp., 72 Fed. Res. Bull. 146 (1986), and *United Jersey Banks*, 69 Fed. Res. Bull. 565 (1983), because in each of these decisions the Board approved the provision of brokerage execution services precisely because the broker did not provide investment advice. We do not read these decisions as so holding and, thus, find that they are not inconsistent with the Board's decision in this case.

In *Sovran Financial Corp.*, the Board addressed the question of whether a bank subsidiary could provide investment advice about, and underwrite and deal in, government obligations and money market instruments and at the same time provide brokerage services for separate classes of securities. The issue of whether the affiliate could provide investment advice and its brokerage services for the same classes of securities was not before the Board. In rejecting SIA's contention that the subsidiary's activities would violate the Act, the Board stated:

> SIA's assertions . . . are not warranted because they presuppose an integration of securities brokerage with investment advisory and research services—an integration that . . . is not involved in Applicant's proposal. As in . . . (*Schwab*), SIC will not have a "salesman's stake" or other promotional interest in any securities it brokers because it will not purchase or sell any such securities for its own account, and will not provide *any* investment advice or research in connection with its securities brokerage services.

72 Fed. Res. Bull. at 148 (emphasis in original). This is not, as SIA argues, a finding that the provision of brokerage services is permissible only in the absence of investment advice. The Board's statement was merely that SIA's argument was misplaced because the issue was not presented by the facts of the case. The statement is, therefore, not inconsistent with the Board's decision in this case.

Similarly, in *United Jersey Banks*, there is no indication that the applicant proposed to combine brokerage services with investment advice. In approving the application to provide

discount brokerage services, the Board noted that because the broker

> would not deal in securities for its own account and would not actively promote any particular security through the provision of investment advice or otherwise, it would not have the "salesman's stake" or promotional interest in the success or failure of any particular issue of securities that led Congress to mandate a separation of banking from certain types of securities-related activities.

69 Fed. Res. Bull. at 568. Even if this statement were addressed to an issue that was before the Board, it would not be inconsistent with the Board's decision here. The Board in the statement above did not hold, or imply, that the provision of investment advice would be impermissible when an affiliate does not deal in securities for its own account. Thus, we do not find the Board's decision here to be inconsistent with any of its previous holdings.

Because we find that the Board's decision is a reasonable interpretation of the language and legislative history of section 20, we deny the petition for review.

It is so ordered.

APPENDIX B

FEDERAL RESERVE SYSTEM

National Westminster Bank PLC
London, England

NatWest Holdings, Inc.
New York, New York

Order Approving Application to Engage in Combined Investment Advisory and Securities Execution Services

National Westminster Bank PLC, London, England, and NatWest Holdings, Inc., New York, New York (collectively, "Applicant" or "NatWest"), both bank holding companies within the meaning of the Bank Holding Company Act ("BHC Act"), have applied for the Board's approval under section 4(c)(8) of the BHC Act (12 U.S.C. § 1843(c)(8)), and section 225.23(a)(3) of the Board's Regulation Y (12 C.F.R. § 225.23(a)(3)), to form a *de novo* subsidiary, County Securities Corporation, New York, New York ("CSC"), and thereby engage in the following activities:

(1) providing portfolio investment advice to "Institutional Customers";[1]

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1 An Institutional Customer is defined by Applicant to be a person that is:

(1) a bank (acting in an individual or fiduciary capacity); an insurance company; a registered investment company under the Investment Company Act of 1940; or a corporation, partnership, proprietorship, organization or institutional entity that regularly invests in the types of securities as to which investment advice is given, or that regularly engages in transactions in securities;

(2) an employee benefit plan with assets exceeding $5,000,000, or whose investment decisions are made by a bank, insurance company or investment advisor registered under the Investment Advisors Act of 1940;

(*footnote continued*)

(2) providing securities execution (brokerage) services, related securities credit activities pursuant to the Board's Regulation T, and incidental activities such as offering custodial services and cash management services, in each case for institutional customers, and in each case under circumstances where the securities brokerage services are restricted to buying and selling securities solely as agent for the account of such customers;

(3) furnishing general economic information and advice, general economic statistical forecasting services and industry studies to institutional customers; and

(4) serving as an investment advisor (as defined in section 2(a)(20) of the Investment Company Act of 1940) to investment companies registered under that act.[2]

CSC will not act as principal or take a position (*i.e.*, bear the financial risk) in any securities it brokers or recommends. CSC will execute a transaction only at the direction of a customer and will not exercise discretion with respect to any customer account. CSC intends to offer investment advice, as well as to provide securities execution services, to institutional customers on an integrated basis, *i.e.*, CSC will not charge an explicit fee for the investment advice and will receive fees only for transactions executed for customers. If its customers desire, CSC will provide investment advice or execution services separately and

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(3) a natural person whose individual net worth (or joint net worth with his or her spouse) at the time of receipt of the investment advice or brokerage services exceeds $5,000,000;

(4) a broker-dealer or option trader registered under the Securities Exchange Act of 1934, or other securities professional; or

(5) an entity all of the equity owners of which are institutional customers.

2 NatWest further expects that CSC will provide investment advice and securities execution services directly to NatWest affiliates. Such services are permissible servicing activities under section 225.22(a) of Regulation Y, 12 C.F.R. § 225.22(a).

for individual fees. CSC's activities will be conducted throughout the United States from offices of CSC initially located in New York City.

Notice of the application, affording interested persons an opportunity to submit comments on the proposal, has been duly published (50 *Federal Register* 43,790 (1985)). In response to its request for comments on this application, the Board received three written comments opposing the proposal, and 23 in favor of the proposal. Among the comments opposing the application were those of the Securities Industry Association (the "SIA"), a national trade association of the securities industry.[3]

National Westminster Bank PLC ("NatWest Bank PLC"), with approximately $104.7 billion in total consolidated assets as of December 31, 1985, is the fourteenth largest banking organization in the world and provides a full range of retail and wholesale banking services worldwide. In the United States, NatWest Bank PLC operates four representative offices, three nonbanking subsidiaries (engaged in factoring, commercial finance and raising funds), branches in New York and Chicago, and an agency in San Francisco. NatWest Bank PLC also controls Applicant NatWest Holdings, Inc., and its subsidiary National Westminster Bank USA, N.A. ("Bank"), New York, New York, which holds total deposits of approximately $7 billion as of year-end 1985.

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3 The Investment Company Institute stated that it objected to the proposal on the grounds set forth in the SIA's protest. The third protestant, Option Advisory Service, Inc. ("OAS"), alleges that NatWest intends by the application to help raise funds for "greenmailing" schemes to be conducted by certain individuals to takeover various corporations, in violation of the securities laws, and has requested a hearing on this assertion. The Board has carefully reviewed the submissions of OAS and has determined that these allegations do not raise a genuine issue of material fact that would warrant a hearing. CSC would not engage in making loans to finance corporate takeover attempts or in arranging financing for such purposes. In addition, the Board finds no basis for OAS's assertion that Bank's financing of previous takeover attempts constitutes aiding and abetting alleged violations of the securities laws connected with such attempts. Accordingly, OAS's request for a hearing is denied.

This application raises two principal questions: first, whether CSC's proposed activities are so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act; and second, whether the conduct of such activities by a member bank affiliate (such as CSC) would violate section 20 or 32 of the Glass-Steagall Act ("Act"), which generally require a separation between member banks and companies principally or primarily engaged in the underwriting or public sale of securities. Upon consideration of the entire record of the application and for the reasons set forth below, the Board concludes that the proposed activities are closely related to banking and a proper incident thereto under section 4(c)(8) of the BHC Act, and that consummation of the proposal would not result in a violation of the Glass-Steagall Act. Accordingly, the Board has determined to approve the application.

I. *Whether the Proposed Activity is Closely Related to Banking*

In its evaluation of the application, the Board must initially determine whether the proposed activity is so closely related to banking as to be a proper incident thereto within the meaning of section 4(c)(8) of the BHC Act. Section 4(c)(8) imposes a two-step test for determining the permissibility of nonbanking activities for bank holding companies: (1) whether the activity is closely related to banking; and (2) whether the activity is a "proper incident" to banking—that is, whether the proposed activity can reasonably be expected to produce benefits to the public that outweigh possible adverse effects.[4]

Based on guidelines established in the *National Courier* case, a particular activity may be found to meet the "closely related to banking" test if it is demonstrated that banks generally have in fact provided the proposed activity; that banks generally provide services that are operationally or functionally so simi-

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4 *See Board of Governors* v. *Investment Company Institute*, 450 U.S. 46 (1984) ("*ICI II*"); *National Courier Ass'n* v. *Board of Governors*, 516 F.2d 1229 (D.C. Cir. 1975) ("*National Courier*").

lar to the proposed activity so as to equip them particularly well to provide the proposed activity; or that banks generally provide services that are so integrally related to the proposed activity as to require their provision in a specialized form.[5] However, the *National Courier* guidelines are not the exclusive basis for finding a close relationship between a proposed activity and banking.[6]

A. *Current Provisions of Regulation Y*

The Board has determined that the activities of providing portfolio investment advice, furnishing general economic information and advice, and serving as an investment advisor to a registered investment company, are permissible for bank holding companies. 12 C.F.R. § 225.25(b)(4)(iii), (iv), and (ii). In rejecting a challenge to the Board's determination, the Supreme Court stated that the "services of an investment advisor are not significantly different from the traditional fiduciary functions of banks," and that "banks have engaged in that sort of activity [to manage the investment portfolios of its advisees] for decades." *ICI II*, 450 U.S. at 55.

The Board has also determined that securities brokerage services, related securities credit activities, and related incidental services are permissible for bank holding companies if the securities brokerage services are conducted solely as agent for the account of customers and do not include securities underwriting, dealing, or investment advisory or research services. 12 C.F.R. § 225.25(b)(15). In its decision affirming the Board's approval of the acquisition by BankAmerica Corporation of the discount broker, Charles Schwab & Co., the Supreme Court found that:

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5 *National Courier*, 516 F.2d at 1237.

6 The Board has stated that in acting on a request to engage in a new nonbanking activity, it will consider any other factor that an applicant may advance to demonstrate a reasonable or close connection or relationship of the activity to banking. 49 *Federal Register* 794, 806 (1984); *Securities Industry Ass'n* v. *Board of Governors*, 104 S. Ct. 3003, 3006 n.5 (1984) ("*Schwab*").

> Banks long have arranged the purchase and sale of securities as an accommodation to their customers . . . [and] in substance the brokerage services that Schwab performs for its customers are not significantly different from those that banks have been performing for customers for years.

Schwab, 104 S. Ct. at 3008-3009.

The SIA argues that NatWest has failed to demonstrate that the offering of combined securities brokerage and investment advice is closely related to banking under any permissible standard. The Board has, however, determined, upon a review of general banking practices and the record developed in the course of its consideration of the application, including the comments of the SIA, that the combination of investment advice and securities brokerage services as proposed by CSC is closely related to banking.

As the Board noted in approving the Schwab proposal, Schwab was a "discount" broker. Unlike full-service brokers, Schwab did not offer investment advice and its commissions were significantly lower than those typically charged by full-service brokers, which usually do provide investment advice.[7] In providing that the discount brokerage services permissible under Regulation Y do not include investment advice or research services, the Board stated that such a restriction was appropriate because the regulation was intended to incorporate into Regulation Y the Board's decision on the Schwab proposal. The Board noted that, during consideration of that proposal, no record was developed on which to assess the implications of providing securities brokerage and investment advisory services together.[8] The restriction on discount broker-

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7 *BankAmerica Corporation/Charles Schwab & Co., Inc.*, 69 Federal Reserve Bulletin 105, 106 (1983) ("Schwab Order").

8 48 *Federal Register* 37,003, 37,005 (1983). The Board noted that the investment advice provided by full-service brokers tends to reach a wider segment of the public than the advisory services of companies that offer only investment advice, and that full-service brokers usually look to commissions for executing transactions as compensation for the investment advice provided. These factors are considered in the Board's discussion of the public benefits test below.

age thus was not based on a view that the combination of the two services was necessarily inconsistent with section 4(c)(8) or with the Glass-Steagall Act—instead, the restriction reflects the limited nature of the activity proposed by the particular applicant in the Schwab case.

As the Board noted when it adopted the discount broker regulation, bank holding companies providing investment advisory services pursuant to Regulaton Y, in contrast to full-service brokers, typically charge an explicit fee for such services and thus usually deal with sophisticated customers with substantial amounts of funds to invest. Although CSC proposes to charge for both investment advice and securities execution services on a transaction-related basis, CSC would offer its services only to financially sophisticated institutional customers.[9] Thus, this proposal represents the combination of two activities, previously determined to be closely related to banking, in such a way that the functional nature and scope of the combined activities conducted would not be altered. The fact that CSC would not generally charge an explicit fee for each of the component services is a pricing consideration that does not in the Board's view sufficiently alter the operational characteristics of the combined services so that they lose their close functional connection to banking activities. On this basis, the Board concludes that CSC's proposed activities are closely related to banking.

B. *Functional Similarity to Services Banks Already Provide*

Even if the joint offering of securities and investment advice is viewed as a distinct new activity, the Board concludes that the record supports a finding that the combined activity is closely related to banking. Under the second *National Courier* test, a proposed activity is closely related to banking if banks generally provide services that are so functionally similar to the proposed activity as to equip bank holding companies particu-

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9 As noted above, Applicant has committed that separate fees will be charged for customers desiring to utilize separately investment advisory and securities execution services.

larly well to provide the proposed activity. Currently, banks provide a variety of services that equip them with the expertise to offer a combined investment advisory/securities execution service.

Banks currently provide both investment advice and securities execution services in separate departments or subsidiaries and for separate fees.[10] In addition, banks currently do combine, at least to some extent, their separate investment advisory and securities execution services. Bank trust departments, which provide a variety of investment advisory services, may in certain circumstances use an affiliated discount broker to purchase or sell securities on behalf of the bank's trust customers. Under guidelines issued by the Office of the Comptroller of the Currency ("OCC"),[11] banks may effect securities transactions for trust accounts through an affiliated discount broker, if the transactions are performed on a non-profit basis. Under these guidelines, and similar Board staff guidelines,[12] a bank trust department may use an affiliated broker to receive extra fees for brokerage services where specific authority is given to effect transactions through the affiliate within the appropriate governing instrument, or by local law, or where all beneficiaries authorize. In many respects, this linkage between the bank's trust department and discount brokerage operations

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10 National banks may lawfully provide securities brokerage services, *Securities Industry Ass'n* v. *Comptroller of the Currency*, 577 F. Supp. 252 (D.D.C. 1983), *aff'd*, 758 F.2d 739 (D.C. Cir. 1985), *cert. denied*, 106 S. Ct. 790 (1986) ("*Security Pacific*"). The FDIC has indicated that state nonmember banks may provide these services. *See* 48 *Federal Register* 22,989 (1983). The Securities and Exchange Commission has recently stated its belief that over 1,000 banks are publicly soliciting securities brokerage business, often in separate departments or subsidiaries. *See* 50 *Federal Register* 28,385, 28,386 (1985). As noted above, banks have traditionally provided investment advisory services, generally through their trust departments.

11 OCC, Trust Banking Circular No. 23 (Oct. 4, 1983).

12 FRRS § 3-447.11 (Sept. 19, 1983).

closely resembles the full-service brokerage services proposed here.[13]

Finally, the record reflects that banks offer brokerage-like services for specific types of financial instruments, and at the same time provide general or specific advice with respect to such instruments. For example, as part of their permissible government securities underwriting and money market operations, banks buy and sell as agent for customers, and offer specific investment advice with respect to, obligations of the United States, certain obligations of various States and municipalities, and certain money market instruments.[14] Banks also

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13 The OCC has also approved the more explicit linkage of separate investment advisory and securities brokerage operations subsidiaries of a national bank, allowing a national bank's investment advisory subsidiary to refer its customers to the bank's brokerage subsidiary. *Decision of the Comptroller of the Currency Concerning an Application by American National Bank of Austin, Texas, to Establish an Operating Subsidiary to Provide Investment Advice* (Sept. 2, 1983), *reprinted in* [1983-1984 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 99,732 ("*American National*"). The advisory activities approved in the *American National* decision included the provision of individualized investment advice to various banks clients, the exercise of discretionary trading authority, and the distribution of investment recommendations and analyses of economic trends in a newsletter. The two subsidiaries would not share employees, office space or telephones, but would share a common name and address. In addition, the two would refer customers to each other, and the advisor's newsletter would be marketed to brokerage customers. The subsidiaries would not share fees or receive fees for referring customers to the other. The legality of this ruling has been challenged in *Securities Industry Ass'n* v. *Conover*, No. 83-3581 (D.D.C. filed Nov. 30, 1983). This lawsuit has been stayed pending the outcome of a lawsuit which is currently before the Supreme Court on the issue of whether discount brokerage offices are bank branches.

14 Member banks are specifically authorized to conduct the underwriting and dealing activities pursuant to sections 16 and 5 of the Glass-Steagall Act. 12 U.S.C. §§ 24 Seventh and 335. The 36 banks that are primary dealers in government securities routinely provide investment advice to their customers concerning those securities. The investment advice in these instances is offered on a non-fee basis. *Manufacturers Hanover Corporation*, 70 Federal Reserve Bulletin 661, 662 (1984).

combine investment advice and execution services with respect to futures contracts on a transaction-related fee basis.[15]

In sum, by linking separate advisory and execution functions in these specific situations, banks now provide services that are very close in function to those proposed by CSC: making recommendations concerning the purchase or sale of securities or other financial instruments and then executing the customer's directions based on these recommendations. Accordingly, the Board believes that these existing activities of banks would equip bank holding companies particularly well to provide the securities execution and advisory services proposed by CSC as a combined service, and support a determination that the proposed activities are closely related to banking.[16]

II. *The Proposed Activity as a Proper Incident to Banking*

With regard to the "proper incident" requirement, section 4(c)(8) of the BHC Act requires the Board to consider whether

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15 National banks have been permitted to execute and clear futures contracts, for the account of customers, through their operations subsidiaries that serve as futures commission merchants. *J.P. Morgan & Co. Incorporated*, 71 Federal Reserve Bulletin 251 (1985). The provision of futures advisory services by national banks is also lawful. *Manufacturers Hanover Corporation*, 70 Federal Reserve Bulletin 369, 370 (1984). Commercial banks also engage in providing foreign exchange advice and transaction services to their customers. *See Hong Kong and Shanghai Banking Corporation, et al.*, 69 Federal Reserve Bulletin 221 (1983).

16 The SIA argues that the combined activity is not closely related to banking because services provided by bank trust departments differ significantly from those proposed here. The SIA asserts in particular that bank trust departments may not utilize affiliated brokers to buy and sell securities for customers. However, as noted earlier, neither the OCC nor the Board completely precludes a bank trust department from the use of affiliated brokers. Moreover, even if banks may not engage in a particular activity, the activity may nevertheless be closely related to banking. Under the framework set forth in the BHC Act, nonbank affiliates of banks are allowed greater latitude in the conduct of nonbanking activities than are banks themselves. In *ICI II*, the Supreme Court expressly stated that under the BHC Act (as well as the Glass-Steagall Act) a bank affiliate may engage in activities that would be impermissible for the bank itself. 450 U.S. at 63-64.

the performance of the activity by an affiliate of a holding company "can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices." As discussed below, the Board finds that on balance consummation of this proposal can reasonably be expected to result in public benefits outweighing possible adverse effects.

A. *Public Benefits*

In the Board's view, the proposal will result in some public benefits. CSC will enter the brokerage market as a *de novo* competitor. Although the full-service brokerage industry is competitive and there are no significant barriers to entry into the market, the entry of a new competitor into the field should provide some increased competition.[17] In addition, the ability to obtain both investment advice and the execution of securities transactions at the same location will result in increased efficiencies for CSC through the sharing of facilities, equipment and personnel.

B. *Adverse Effects*

The SIA argues that this proposal would lead to such significant adverse effects that denial of the application is required. Applicant argues that the limitation of the proposed services to institutional customers, its series of commitments regarding the conduct of the proposed activities, as well as existing statutes and regulations regulating these activities, all guard against adverse effects such as possible conflicts of

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17 *See Independent Ins. Agents of America* v. *Board of Governors*, 736 F.2d 468, 474 (8th Cir. 1984) ("[T]he mere fact of new entr[y] into the field is indicative of some degree of increased competition"). *See also United City Corporation*, 71 Federal Reserve Bulletin 662, 663 (1985); 12 C.F.R. § 225.24 ("Unless the record demonstrates otherwise, the commencement or expansion of a nonbanking activity *de novo* is presumed to result in benefits to the public through increased competition").

interest. The Board, having considered the facts of record and the allegations of all of the parties, finds that the proposal is not likely to result in any significant adverse effects.

1. *Unsound Banking Practices*

Damage to Bank Reputation. The SIA contends that depositors might lose confidence in Bank if investments made on the recommendation of its affiliate CSC do poorly. Based on the record, the Board finds no substantial basis for this contention.

The Board has long held the view that, as a practical matter, a bank cannot be completely insulated from the fortunes of a nonbank subsidiary of its holding company, since the securities markets, the general public, and the holding company itself typically look upon the bank and its affiliate as part of a consolidated organization. The Board has also recognized, however, that conducting nonbanking activities in a separate affiliate can to some extent prevent problems associated with the nonbanking activity from affecting the bank. The Board regards as a significant factor in its approval of this proposal Applicant's commitment that it will maintain a functional and corporate separation between CSC and other NatWest affiliates.

In particular, Applicant has stated that CSC will be maintained, and will hold itself out to the public, as a separate and distinct corporate entity with its own name, properties, assets, liabilities, books and records. Except for the provision of investment advice and execution services directly to other NatWest affiliates (as a permissible servicing activity under section 225.22(a) of Regulation Y), NatWest has also stated that CSC will conduct its business separate from other NatWest affiliates, and its agreements with customers will indicate that CSC is solely responsible for its contractual obligations and commitments. All of CSC's notices, tickets, advice, confirmations, correspondence and similar documentation will be clearly imprinted so as to avoid confusion on the part of institutional customers or others between CSC's business and that of any other entity. In addition, CSC's offices will either

be separate from those of other NatWest affiliates or, in the case of offices established in a building in which another NatWest affiliate also has offices, in areas separate from areas utilized by such affiliate.

Applicant has also committed that no officer of CSC will serve as an officer either of its overseas parent NatWest Bank PLC, Bank, or of any subsidiary of the Bank.[18] Moreover, no director of CSC will also be a director of NatWest Bank PLC, Bank, or any of Bank's subsidiaries.[19]

In addition, CSC's corporate name would be different from that of Bank and its parent bank holding companies. CSC's name does, however, reflect its affiliation with an overseas merchant bank, County Bank, U.K. Since CSC expects to deal largely with U.S. customers, this current similarity in name does not appear significant for purposes of an association in the public's mind between CSC and its U.S. bank affiliate.

Although it is possible that a particular customer of CSC may withdraw funds from Bank on the basis that the investment advice provided by CSC was not to the customer's liking, this possibility does not, in the Board's judgment, constitute a significant adverse effect. First, existing bank investment advisory affiliates (and banks themselves in investing trust assets or acting in another traditional advisory capacity) are already subject to this potential loss of depositor confidence. No evidence has been presented indicating that public confidence in banks has been seriously impaired because of the provision of investment advice either directly by the bank or through an affiliate. In addition, the institutional customers to be served by CSC would be financially sophisticated and thus would be less likely to place undue reliance on the advice received. Furthermore, neither CSC nor Bank would purchase specific investments with their own funds, so that should investments

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18 In addition, no officer of CSC engaged in providing investment advisory or brokerage services will also provide such services on behalf of any other NatWest affiliate.

19 It is anticipated, however, that certain directors of CSC may also be directors of other subsidiaries of NatWest Bank PLC.

recommended by CSC prove unsuccessful, the public and depositors should understand that the banking organization itself would not suffer serious financial losses.

In addition, Applicant's commitment not to permit the exchange of confidential information (including customer and depositor lists and information regarding extensions of credit by any NatWest affiliate) between CSC and its affiliates further limits the potential that depositors of NatWest's affiliated bank might be solicited by CSC for their business, and would further mitigate the potential for loss of depositor confidence.

In any event, both the Board and the Supreme Court have recognized that the public association between bank and nonbank subsidiaries of the same parent bank holding company cannot be completely eliminated, but as well that this factor does not represent grounds for denial of a proposal. Here, both Applicant and the Board have adopted certain restrictions on the conduct of the proposed activity in order to mitigate such a public association. The Supreme Court, in its *ICI II* decision, specifically relied on the Board's imposition of similar restrictions on the relations between a bank holding company investment advisor and its affiliates in approving a Board regulation permitting bank holding companies to act as investment advisors to closed-end investment companies. The Court stated that:

> These restrictions would prevent *to a large extent* the association in the public mind between the bank and the investment company, as well as the resulting connection between public confidence in the bank and the fortunes of the investment company.

450 U.S. at 67 n.39 (emphasis added). In view of the provisions for corporate separateness proposed by Applicant, the fact that brokerage transactions by CSC would be conducted only as agent, the lack of any evidence that depositor confidence would be impaired, as well as the other factors of record, the Board believes that the public association between NatWest's bank subsidiaries and its securities affiliate will be "prevent[ed] to a large extent" and will not pose an undue risk to the

NatWest holding company system, its banking and nonbanking subsidiaries, or to the soundness of the banking system generally.

Lack of Impartial Credit. The SIA also alleges that NatWest's banks might be tempted to make imprudent loans to corporations in which CSC's customers had invested at its recommendation, presumably in order to boost the market value of the stock and thereby increase CSC's brokerage commissions, attract new customers, or preserve corporate good name and reputation. However, it would not be rational for a bank to risk making unsound loans solely to obtain a comparatively insignificant increment in revenues for a brokerage affiliate from new brokerage and investment advisory customers. In addition, the likelihood of damage to corporate good name as a result of imprudent lending dwarfs any gain in income, or the benefit of maintaining existing customers, arising from such imprudent practices.

In addition, NatWest has committed that CSC will not transmit its advisory research or recommendations to the commercial lending department of any NatWest affiliate, so that those responsible for making credit decisions on commercial loans would not routinely be aware of which particular securities CSC has recommended. The Board also notes that, as is the case with many of the potential abuses cited by the SIA, any banking organization that provides investment advice is subject to the same possible risk of impairment of impartial lending practices. However, no showing has been made that unsound lending practices have been attributable to the provision of investment advisory services.[20]

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20 Nor is it realistic to expect that Bank would make unsound loans to enable CSC's customers to purchase securities recommended by CSC. CSC will not refer its customers who seek to purchase securities on credit to any affiliated bank. Nor will any bank affiliated with CSC have any established program for extending credit for the purchase of securities by customers of CSC. Instead, CSC itself would extend margin credit, as provided for in Regulation Y.

Shore Up Failing Securities Affiliate. Another potential unsound banking practice that is cited as arising from the affiliation of a banking organization with a securities firm is the prospect of unwarranted extensions of credit by a bank to shore up its securities affiliate if the affiliate encountered financial difficulties.[21]

However, CSC will not be acting as a principal to any extent or engaging in speculative ventures. Since its own funds will not be at risk in any transaction, significant losses by CSC as a result of its securities transactions are not likely. In addition, loans from NatWest's affiliated bank to CSC would be restricted by the lending limitations of section 23A of the Federal Reserve Act.[22]

2. *Conflicts of Interest*

Provision of Biased Investment Advice. The SIA alleges that adding an advisory service to a brokerage operation could give CSC opportunities to recommend to its customers the purchase or sale of securities of issuers to which its bank affiliates had extended credit, especially where the proceeds of the securities would be used to repay loans to the bank affiliates. However, to a large extent, CSC's investment advice is likely to relate to securities traded in the secondary market, *i.e.*, securities that have already been issued and are now held by the public. Even if CSC were to recommend newly issued securities, the federal securities laws would require public disclosure of the expected use of the proceeds of the issue.[23]

In addition, NatWest has committed to create a "Chinese Wall" between its bank and its securities affiliate—similar to those walls created by banks with regard to the provision of trust services.[24] Thus, CSC personnel will not be given customer lists and other confidential information obtained by

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21 *See Investment Company Institute* v. *Camp*, 401 U.S. 617, 631 (1971) ("*ICI I*").

22 2 U.S.C. § 371c.

23 *See, e.g.*, 15 U.S.C. § 77aa(13).

24 *See, e.g.*, FRRS § 3-1550 (March 17, 1978).

CSC's affiliates in connection with their commercial banking operations. This limitation would minimize the possibility that CSC employees would be aware of potential benefit to affiliated banks as a result of CSC's recommendations. Moreover, since CSC's customers will be financially sophisticated institutions or individuals, they should be better able to detect investment advice that is motivated by self-interest.

The Board notes that in reviewing an application under section 4(c)(8) of the BHC Act, the Board is entitled to rely on an applicant's commitments, the imposition of conditions, or on statutory and regulatory provisions in concluding that adverse effects will not occur.[25] The Board has ample authority to enforce compliance with these commitments, conditions, and regulatory provisions.[26]

Moreover, the Board believes that the possibility of biased investment advice represents a potential abuse that conceivably could occur any time a bank holding company provides investment advice alone, regardless of whether brokerage services would also be provided. None of the commenters has identified any evidence that bank holding companies providing investment advice under the existing regulatory provisions have improperly made investment recommendations in order to benefit the commercial lending operations of affiliated banks. On balance, the Board finds that the addition of brokerage to

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25 *Independent Ins. Agents of America* v. *Board of Governors*, 646 F.2d 868, 869-870 (4th Cir. 1981); *Alabama Ass'n of Ins. Agents* v. *Board of Governors*, 533 F.2d 224, 250 n.25 (5th Cir. 1976), *modified on other grounds*, 558 F.2d 729 (5th Cir, 1977), *cert. denied*, 435 U.S. 904 (1978). The Board notes that NatWest engages in extensive merchant banking activities outside of the United States, including acting as a dealer in securities. However, NatWest has committed that the securities operations of its overseas affiliates will be limited to transactions that do not constitute dealing in securities in the United States. Moreover, in any transaction by CSC in which a NatWest affiliate is a counter-party (*e.g.*, where CSC would purchase securities desired by a customer from its affiliate's inventory), NatWest has committed that CSC will disclose this fact to its customer and obtain the customer's specific consent for the transaction.

26 12 U.S.C. § 1818(b)-(*l*), 1847(b).

a holding company's investment advisory does not appear to increase the likelihood of this kind of abuse.

Churning and Unsuitability. As noted above, full-service brokers do not usually charge an explicit fee for investment advice. Thus, these brokers look to commissions from buying and selling securities for customers as compensation for advisory services.[27] It has been recognized that in the case of nonbank full-service brokers, the joint pricing of investment advisory and securities execution services might provide an incentive for the broker to give biased advice designed to generate increased trades and thus increase its commissions, *i.e.*, "churning", or for the broker to make recommendations unsuitable for particular customers.[28] CSC, however, like a full-service broker not affiliated with a bank, would be a registered broker-dealer under the Securities Exchange Act, would also be registered under the Investment Advisors Act, and would be a member of the National Association of Securities Dealers. CSC, therefore, would be subject to the antifraud provisions of the Securities Exchange Act of 1934, as well as the general antifraud provisions in applicable regulations, which have been interpreted as prohibiting the churning of customer accounts and the recommending of securities that are not suitable for particular customers.[29]

In addition, the Board believes that other factors associated with this particular application further assure that this kind of tainted advice would not result from this proposal, although the Board does not rely solely on such factors. Applicant's

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27 *See* 47 *Federal Register* 37,005 (1983).

28 Brokerage fees are usually charged for each transaction executed—the higher the volume of transactions, the greater the amount of brokerage income.

29 *See* 15 U.S.C. § 78k and 17 C.F.R. § 240.15c1-2(a), respectively. Section 206 of the Investment Advisors Act (15 U.S.C. § 80b-6), its antifraud provision, also would prohibit such practices. Since CSC at times would provide investment advice for a separate fee, CSC would not be eligible for the exemption from the Advisors Act for registered broker-dealers. *See id.*, § 80b-2(a)(11).

commitment to limit its services only to institutional customers makes it less likely that CSC would be able to churn accounts or make unsuitable recommendations, since these financially sophisticated customers are likely to be aware of many alternative sources of advisory and brokerage services and to have the resources to compare performance and prices. In addition, CSC will not have investment discretion over any customer accounts. In every case, CSC's customers will decide whether a particular purchase or sale transaction will be undertaken.

Moreover, CSC will not require its customers to use both its investment advisory and securities brokerage services, and will charge a separate fee for those customers desiring only investment advise or agency executions. In this regard, the Board has indicated in an analagous context that, "charging a separate fee for advice reduces the possibility for churning because it reduces the incentive to recommend additional trades to generate fees."[30]

Finally, in designating portfolio investment advice as closely related to banking, section 225.25(b)(4) of Regulation Y states that in furnishing such services, bank holding companies and their subsidiaries "shall observe the standards of care and conduct applicable to fiduciaries." Such fiduciary standards would also prohibt the churning of accounts and other self-interested practices. CSC must abide by the fiduciary responsibilities imposed on investment advisors by that section in conducting its proposed services.[31]

3. *Undue Concentration of Resources/Unfair Competition*

In the Board's view, the entry of NatWest into the full-service securities brokerage market to serve institutional cus-

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30 *Manufacturers Hanover Corporation*, 70 Federal Reserve Bulletin 369 (1984) (futures commission merchant activities).

31 To the extent that CSC's full-service brokerage functions are viewed as a new nonbanking activity that is not technically subject to the fiduciary obligations imposed by the terms of section 225.25(b)(4), the Board conditions its approval of the proposal on CSC's observance of the standards of care and conduct applicable to fiduciaries.

tomers would not result in an undue concentration of resources or unfair competition. Since CSC would be a *de novo* entrant into a highly competitive field, this proposal is not likely to produce undue concentration of resources. In addition, the Board finds no evidence in the record indicating that this proposal would result in any unfair or decreased competition.

In sum, based upon a consideration of all the relevant facts, the Board concludes that this proposal may reasonably be expected to result in public benefits that outweigh possible adverse effects. The Board therefore finds that the proposal satisfies the proper incident test under section 4(c)(8) of the BHC Act.

III. *Glass-Steagall Act Considerations*

In its evaluation of the application, the Board has also considered whether CSC's acquisition by Applicant would result in a violation of the Glass-Steagall Act, the popular term for provisions of the Banking Act of 1933, which is designed to insulate commercial banking from certain aspects of the securities business. The Glass-Steagall Act provisions at issue in this proposal are: section 20 (12 U.S.C. § 377), which prohibits the affiliation of any bank that is a member of the Federal Reserve System with any corporation or similar organization that is "engaged principally in the issue, flotation, underwriting, public sale, or distribution" of securities; and section 32 (12 U.S.C. § 78), which prohibits an officer, director or employee interlock between a member bank and a company "primarily engaged" in such activities.

As a result of this proposal, CSC would become affiliated for purposes of section 20 with Bank, a member bank,[32] and would by any measure be engaged principally in the full-service

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32 CSC and Bank would also have some common employees for purposes of section 32. The Board's analysis of whether brokerage activities are covered by section 20 of the Act is equally applicable to section 32 because, as the Supreme Court indicated in its *Schwab* decision, "sections 20 and 32 contain identical language, were enacted for similar purposes, and are part of the same statute." 104 S. Ct. at 3010.

brokerage business. Thus, if CSC's proposed brokerage activities constitute "the issue, flotation, underwriting, public sale, or distribution" of securities, the proposal would result in a violation of section 20.

The SIA argues that the combination of investment advice with buying and selling securities on behalf of customers constitutes the "public sale" of securities. SIA also contends that the combination gives rise to the "subtle hazards" the Glass-Steagall Act was meant to eliminate, such as damage to the bank's reputation and its position as an impartial provider of credit.[33]

For the reasons noted herein, and on the basis of the facts appearing in the record, the Board concludes that the combination of investment advice and execution services as proposed here does not constitute a "public sale" of securities for purposes of section 20 or 32 of the Glass-Steagall Act and that the proposal is consistent with the intent of that Act.

A. *The Public Sale of Securities Under Sections 20 and 32*

In its decision affirming the Board's approval of the acquisition by BankAmerica Corporation of Charles Schwab & Co., the Supreme Court characterized the term "public sale" in section 20 as not applying to a discount broker—a firm that buys and sells securities solely for the account of and at the direction of customers, but that does not provide investment advice. The Court stated that "public sale" should be interpreted by reference to the activites described by the terms surrounding it in section 20—the "issue, flotation, underwriting, and distribution" of securities.[34] The Court further stated that the terms used in conjunction with public sale refer to activities in which a bank affiliate acts for its own account or

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33 It is undisputed that NatWest's proposed activity does not constitute the "issue, flotation, underwriting . . . or distribution" of securities for purposes of sections 20 and 32.

34 *Schwab*, 104 S. Ct. at 3010.

where new issues of securities are distributed to the public on behalf of an issuer.[35] On this basis, the Court concluded that the retail brokerage business at issue in that case did not involve these activities.[36]

Since the broker in that case did not provide investment advice, the *Schwab* decision did not reach the issue of whether a broker, like CSC, that would also provide investment advice would be engaged in the "public sale" of securities. However, in the Board's view, the addition of investment advice to securities execution services as proposed by CSC would not render the combined activity the "public sale" of securities. In providing investment advice in connection with the execution of securities transactions, CSC would act solely as agent for its customers and would not act as a principal (*i.e.*, with its own funds) in buying and selling securities. CSC would not, like many securities firms, make a market in securities with its own funds. Nor would CSC offer securities to the public as agent for the issuer of securities.[37] Thus, CSC's full-service brokerage services would not involve any of the factors used by the Supreme Court in describing the term public sale in section 20.

Indeed, the Supreme Court has concluded that the provision of investment advice to an investment company does not violate the Glass-Steagall Act, even if performed by a bank, provided that the bank does not underwrite any issue of

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35 *Id.*, at 3010 & n. 17. The Court noted that the process by which large blocks of securities are offered to the public by an investment banker acting solely as the agent of the issuer is not technically underwriting, but left open the question of whether this "best efforts" underwriting is covered by the Act, since the brokerage business at issue in *Schwab* did not involve this kind of distribution plan. *Id.*

36 *Id.* While both the Supreme Court and the Board described the activities involved in *Schwab* as executing transactions on the "unsolicited" order of customers, nothing in the analysis of the Court or the Board suggests that lack of solicitation is a decisive factor in determining whether a particular activity is covered by the language of section 20.

37 NatWest has stated that CSC will have no association with a particular issuer and no financial interest in the placement of a particular offering.

securities or purchase any securities of the investment company. *ICI II*, 450 U.S. at 62-63. The combination of similar investment advisory activities, as proposed here, with securities execution services clearly not proscribed by section 20 or 32, does not convert the components into the kind of principal or distribution activity covered under section 20 or 32.[38]

The Board's conclusion that CSC's proposed activities do not constitute the "public sale" of securities for purposes of sections 20 and 32 is consistent with the legislative history of the Act, which reveals that the focus of Congressional concern was the underwriting, dealing and stock speculation activities that were then conducted by banks and their securities affiliates.[39] There is no indication in the legislative history that Congress intended to prohibit the kind of brokerage activities proposed for CSC, where no position is taken in the securities traded or where there is no distribution of securities to the public on behalf of an issuer.[40]

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38 The SIA argues that CSC would be involved in the "public sale" of securities within the ordinary meaning of the term, because in brokering securities that it recommends CSC "touts" or "promotes" specific securities. Such a construction is fundamentally inconsistent with the Supreme Court's interpretation of the term "public sale" in the *Schwab* decision as explained above. Moreover, if the SIA's construction were the correct meaning of the term public sale, then any time a banking organization provided investment advice it would be engaged in the proscribed securities business, since in making investment recommendations an advisor can be viewed as "promoting" specific securities in a general sense.

39 As the Supreme Court stated in *ICI II*:

> The legislative history reveals that securities firms affiliated with banks had engaged in perilous underwriting operations, stock speculation, and maintaining a market for the bank's own stock, often with bank resources. Congress sought to separate national banks, as completely as possible, from affiliates engaged in such activtites.

450 U.S. at 61-62.

40 During congressional consideration of the Glass-Steagall legislation, the scope of permissible bank brokerage activity was not discussed in detail. The relevant legislative history merely states that national banks would be permitted to buy and sell securities for their customers to the same extent as heretofore. S. Rep. No. 77, 73rd Cong. 1st Sess. 16 (1933).

The SIA contends that the proposed activities are contrary to the purposes of the Glass-Steagall Act which, it argues, was meant to take every remedial step within Congress' constitutional power to divorce the banking industry from the securities business. However, it is clear from the terms of the Act itself that Congress did not intend to erect a complete barrier between banking organizations and the conduct of all securities activities. Under section 20, for example, certain types of securities activities, such as underwriting, are proscribed to bank affiliates only if the affiliate is "engaged principally" in that activity; in section 32, an interlock between a bank and a firm engaged in the same activities is proscribed only where the affiliate is "primarily engaged" in these activities. Similarly, the underwriting of a wide range of government securities is expressly authorized to member banks under section 16 of the Glass-Steagall Act.[41]

B. *Banking Practices and Securities Brokerage After Glass-Steagall*

The conclusion that CSC's activities do not involve the "public sale" of securities is consistent with the Board's long-standing position that full-service brokerage activities do not fall within the scope of "public sale" as used in section 32 of the Glass-Steagall Act. In 1934, the Board interpreted the interlock prohibitions of section 32 as not covering agency brokerage activities,[42] and in 1936 incorporated this position

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41 The SIA's reliance on passing references in the legislative history to "brokerage houses" and "commissions" for securities activities is misplaced. These references do not show any intent to prohibit brokerage activities *per se*, but clearly were meant to describe securities firms generally. In the 1930s brokerage houses, in addition to providing brokerage services, also typically acted as principals in dealing in and underwriting securities. These operations are among the activities proscribed by section 20. *See Board of Governors* v. *Agnew*, 329 U.S. 441, 445-46 (1947). In addition, the references in the legislative history pointed out by the SIA, where concern is expressed that the perceived integrity of a bank securities affiliate may have induced the public to purchase particular securities, described circumstances in which the affiliate was functioning as an underwriter, not as a broker.

42 20 Federal Reserve Bulletin 393 (1934).

into its regulation implementing the provisions of section 32, Regulation R.[43] In particular, Regulation R provided that a "broker who is engaged solely in executing orders for the purchase and sale of securities on behalf of others in the open market is not engaged in the business referred to in section 32." This provision has never been altered. In *Schwab*, the Supreme Court expressly relied on this administrative interpretation, finding that the interpretation should apply as well to the terms of section 20, and that the interpretation is consistent with both the plain language and legislative intent of the statute.[44]

Under this interpretation, a broker that combines investment advice with buying and selling securities on behalf of customers similarly is not engaged in the public sale of securities. On the basis of this interpretaion, the Board has allowed numerous interlocks between member banks and full-service brokerage firms,[45] such as Bache and Co. and Harris, Upham & Co., the latter as late as 1962.[46] Indeed, in the Board's administrative action under section 32 of the Glass-Steagall Act at issue in *Board of Governors* v. *Agnew*,[47] the Board excluded brokerage activities in determining whether the securities firm involved in

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43 12 C.F.R. § 218.1, n.1.

44 *Schwab*, 104 S. Ct. at 3010-11.

45 *See* Letter from Merritt Sherman, Secretary of the Board, to Howard D. Crosse, Vice President, Federal Reserve Bank of New York (May 7, 1962) (Harris, Upham determination); Letter from S.R. Carpenter, Secretary of the Board, to R.B. Wiltsee, Vice President, Federal Reserve Bank of New York (June 13, 1954) (Bache and Co. determination).

46 It is clear that these organizations conducted "full-service" brokerage activities, because discount brokerage did not emerge until after May 1, 1975, when fixed brokerage rates were eliminated, and securities firms in response "unbundled" their services to provide investment advice and securities executions services separately. In addition, a 1936 study by the Securities and Exchange Commission regarding broker-dealers indicated that many commission brokers at that time discussed market conditions and furnished specific investment advice to their customers. Securities and Exchange Commission, *Report on the Feasibilty and Advisability of the Complete Segregation of the Functions of Dealer and Broker* at 3 (June 20, 1936).

47 329 U.S. 441 (1947).

that case was primarily engaged in underwriting or the public sale of securities. The Supreme Court's decision upholding the Board's conclusion that the firm was primarily engaged under section 32 left undisturbed the Board's exclusion of brokerage from the securities activities described in section 32.[48]

The Board also notes that immediately after the enactment of Glass-Steagall prominent private banks, which were a chief target of the Act,[49] apparently believed that full-service brokerage did not constitute "issuing, underwriting, selling, or distributing" under section 21 of that Act (12 U.S.C. § 378), and on this basis continued to provide full-service brokerage.[50] Given that section 21 is part of the same statute as section 20, was enacted for the same purpose, and that the two sections have similar language, the apparent industry understanding that full-service brokerage is not the impermissible "selling" of securities for purposes of section 21 further supports the conclusion that full-service brokerage does not constitute the public sale of securities for purposes of section 20.[51]

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48 On judicial review, the member bank directors affected argued that the securities firm was primarily engaged in the brokerage business, because that business generated its largest source of revenue, and that the company, *a fortiori*, could not be primarily engaged in any activity described in section 32. If the Court or the Board had believed that brokerage fell within the ambit of section 32, the combined underwriting and brokerage income would have been so great (constituting well over 50 percent of the firm's business) that there would have been no "primarily engaged" issue to decide.

49 *See e.g., Stock Exchange Practices: Hearings Before the Senate Committee on Banking and Currency on S. Res. 64 and S. Res. 56*, 73rd Cong., 2d Sess. 3975-3981 (1933) (Testimony of Winthrop W. Aldrich, President, Chase National Bank).

50 138 *Commercial and Financial Chronicle* 3869, at col. 1 (June 9, 1934) (Brown Brothers Harriman and Co.); N.Y. Times, June 9, 1934, at 21, col. 3 (J.P. Morgan and Co.).

51 The SIA also contends that full-service brokerage is commonly understood to be unlawful for banks under the Glass-Steagall Act, citing section 16 of the Act and an interpretation of section 21 by the FDIC's General Counsel. Section 16 (12 U.S.C. § 24 Seventh) provides that a national bank's business of dealing in securities shall be limited to purchasing

The Board recognizes that, to a great extent, these interlocks between banks and brokerage firms and the offering of brokerage services by private banks have been discontinued. However, the Board believes the fact that banks (and bank holding companies) are not currently providing full-service brokerage activities does not reflect any common understanding that such activities are prohibited by the Act. As explained above, some private banks did continue full-service brokerage after the effective date of the Glass-Steagall Act. In any event, the abandonment of these services may have been caused by a variety of factors.[52] Accordingly, the failure of banks and bank holding companies to engage in brokerage activities until recently is not determinative of the lawfulness of these activities under the Act. For example, the courts have recently upheld the offering of discount brokerage services by bank

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and selling securities "without recourse, solely upon the order and for the account of customers" and not for the bank's own account. It is not clear that section 16 prohibits for member banks the types of activities at issue here, since under CSC's proposal the customer must direct each trade executed by the broker, even when CSC recommends the transaction.

Moreover, even if the SIA is correct that banks may not provide full-service brokerage directly, this conclusion does not mean that an affiliate would be so prohibited under section 20. The Glass-Steagall Act prescribes different limitations on member banks than it does on their affiliates, allowing, as the Supreme Court has stated, a broader spectrum of activity for affiliates. ICI II, 450 U.S. at 63-64.

52 The Comptroller of the Currency effectively limited the conduct of such activities by national banks when, for over 20 years, he gave section 16 of the Act (which applies to direct securities activities of banks) a restrictive reading, confining such activities solely to an (originally no-cost) "accommodation service" for customers. These limitations have now been rejected as inconsistent with the statue. *See Security Pacific, supra.* Further, it was only in the late 1960s that large banks formed bank holding companies to engage in nonbanking activities. In addition, commenters have noted that banks traditionally had not considered the brokerage market very profitable, and banks could have declined to enter the market on that basis. *See* Note, *National Banks and the Brokerage Business: The Comptroller's New Reading of Glass-Steagall Act,* 69 Va. L. Rev. 1303 (1983).

affiliates and by banks directly, even though banking organizations had not provided such services before.[53]

C. *The Subtle Hazards Implicated by Glass-Steagall*

The SIA also argues that regardless of whether such brokerage or investment advisory activities are permissible separately, the combination of securities execution services and investment advice raises the potential for the creation of those subtle hazards[54] that Congress identified with the combination of commercial banking and the securities business, and that Congress sought to avoid through enacting the Glass-Steagall Act.[55]

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53 *Schwab*, *supra*; *Security Pacific*, *supra*.

54 *ICI I*, 401 U.S. at 638, *ICI II*, 450 U.S. at 63. The Supreme Court in *ICI II* summarized these subtle hazards as follows:

> Because the bank and its affiliate would be closely associated in the public mind, public confidence in the bank might be impaired if the affiliate performed poorly. Further, depositors of the bank might lose money on investments purchased in reliance on the relationship between the bank and its affiliate. The pressure on banks to prevent this loss of public confidence could induce the bank to make unsound loans to the affiliate or to companies in whose stock the affiliate has invested. Moreover, the association between the commercial and investment bank could result in the commercial bank's reputation for prudence and restraint being attributed, without justification, to an enterprise selling stocks and securities. Furthermore, promotional considerations might induce banks to make loans to customers to be used for the purchase of stocks and might impair the ability of the commercial banker to render disinterested advice.

450 U.S. at 66 n. 38.

55 The SIA specifically cites:

> (1) the loss of confidence in banks if investments made on the recommendation of their affiliates went bad;
>
> (2) NatWest's " 'pecuniary incentive' in promoting the sale of a particular security" for a transaction-related fee will provide the potential for biased investment advice;
>
> (3) the touting of securities issued by corporate borrowers in order to pay off pre-existing loans to its bank affiliates; and

(*footnote continued*)

At the outset, the Board notes that in its decisions under the Glass-Steagall Act, the Supreme Court has not relied on the possibility of "subtle hazards" as determinative of the legality of a particular activity, where the activity is permissible under the literal terms of the statute. The Court has examined the potential for subtle hazards in order to confirm that the literal interpretaion of the statute is correct or to shed light on possibly ambiguous statutory language.[56] Here, as demonstrated by a contemporaneous and unchanged administrative interpretation that has been confirmed by the Supreme Court in the *Schwab* opinion, full-service brokerage does not fall within the literal terms of "public sale" or the other securities functions described in sections 20 and 32 of the Act.

Moreover, after reviewing CSC's proposed activities in light of the hazards the Glass-Steagall Act was enacted to eliminate, the Board finds that the potential that such hazards will occur as a result of the proposal does not cast doubt on the correctness of the longstanding interpretation that full-service brokerage is not covered by the terms of sections 20 and 32. Like the broker involved in *Schwab*, CSC will act solely as agent and its assets would not be "subject to the vagaries of the securities markets."[57] The Board also notes that virtually all of the potential hazards cited by the SIA as resulting from the proposal (such as possible damage to the reputation of the affiliated bank due to poor performance of recommended investments, possible touting of securities issued by borrowers to pay off loans from an affiliated bank, and possible unsound loans to issuers whose securities have been recommended), are equally as likely to occur when a banking organization provides investment advice alone. The fact that provision of

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(4) unwarranted extensions of credit to corporations whose securities have been recommended.

56 *See ICI I*, 401 U.S. at 629-38; *ICI II*, 450 U.S. at 66-67; *Securities Industry Ass'n* v. *Board of Governors*, 104 S. Ct. 2979, 2989-91 (1984) ("*Bankers Trust*"); *Schwab*, 104 S. Ct. at 3011.

57 *See* 104 S. Ct. at 3011.

investment advice is not unlawful under the Act indicates that the hazards cited by the SIA were not considered to be of such significant concern as to require a legal prohibition. In addition, as noted above, no evidence has been cited that those investment advisory services, conducted under the framework established by the Board, have produced any conflicts of interests or other hazards.

In any event, each of the potential hazards advanced by the SIA has been thoroughly considered in connection with the Board's analysis of this proposal under section 4(c)(8) of the BHC Act. As explained in the Board's section 4(c)(8) analysis, CSC's affiliation with a member bank, as structured by Applicant, will not produce such significant potential hazards so as to undermine the longstanding administrative interpretation that investment advice and brokerage are not covered by sections 20 and 32 and are consistent with the congressional intent reflected in the Act. For example, there is no significant potential for loss of confidence in an affiliate bank as a result of this proposal, given the strict operational separation proposed between CSC and other NatWest affiliates, the fact that the public and bank depositors should understand that CSC would not commit its own funds to any specific investments, and that depositor lists would not be transmitted from any affiliated bank to CSC. With respect to the potential for biased investment advice resulting from the proposed transaction-related fee arrangement, the Board has noted that the federal securities laws prohibit self-interested advisory practices such as churning and unsuitable recommendations. CSC would serve only institutional customers that would be sensitive to less than impartial investment advice, and CSC would provide investment advice and execution services for separate fees if customers wished.

In addition, as explained above, the Board also finds that there is no significant potential that CSC would recommend securities the proceeds of which would be used to pay existing loans made by an affiliated bank, because the securities laws require disclosure of the intended use of the proceeds, and because information relating to loans made by NatWest affili-

ate banks would not be made available to CSC. Finally, with respect to the potential for unwarranted loans to companies whose securities CSC has recommended, the Board has noted that the expected benefit of such conduct would likely be outweighed by the potential losses resulting from the bad loans, and that information relating to the particular recommendations made by CSC would not be provided to NatWest affiliates.

In making its judgment about the lack of significant hazards associated with this proposal, the Board has relied on various commitments entered into by NatWest limiting the scope of the proposed operations, and has imposed certain conditions on the conduct of the proposed activity. The Board believes that its reliance on the commitments and conditions does not constitute the kind of regulatory approach the Supreme Court has disfavored in constructions of the Glass-Steagall Act.[58] The Supreme Court has explicitly recognized that where a particular activity is permissible under the terms of the Act, the Board may impose restrictions designed to assure that the activity is insulated from the subtle hazards associated with investment banking.[59] *ICI II*, 450 U.S. at 62, 66-67 n.39. The commitments of Applicant and the reasons for them are discussed above in connection with the consideration of the section 4(c)(8) factors.[60]

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58 Bankers Trust, 104 S.Ct. at 2988.

59 *In Bankers Trust*, the Supreme Court made clear that an agency may not rely on regulatory guidelines to overcome the explicit language of the Glass-Steagall Act, if that language expressly applies to the activity in question. Here, as explained above, the explicit language of the Act does not apply to CSC's activities. The Board also has the independent authority under section 4(c)(8) of the BHC Act to impose conditions to assure compliance with that provision.

60 In any event, the fact that an applicant has imposed limitations on a proposed activity designed to assure that potential hazards do not occur, does not necessarily support the conclusion that without each of the limitations, the activity would implicate the subtle hazards that motivated the Glass-Steagall Act. Indeed, in the Board's experience, an applicant may agree to limitations that are more stringent than what is required by law, simply to

IV. *Conclusion*

Based upon the foregoing and other considerations reflected in the record, the Board has determined that the public benefits associated with consummation of this proposal can reasonably be expected to outweigh possible adverse effects, and that the balance of the public interest factors that the Board is required to consider under section 4(c)(8) of the BHC Act is favorable. Accordingly, the application is hereby approved, subject to the commitments made by Applicant and the conditions set forth in this Order. This determination is further subject to all of the conditions set forth in the Board's Regulation Y, including those in sections 225.4(d) and 225.23(b), and to the Board's authority to require modification or termination of the activities of the holding company or any of its subsidiaries as the Board finds necessary to assure compliance with the provisions and purposes of the BHC Act and the Board's regulations and orders issued thereunder, or to prevent evasion thereof.

This transaction shall not be consummated later than three months after the effective date of this Order, unless such period is extended for good cause by the Board, or by the Federal Reserve Bank of new York, pursuant to delegated authority.

By order of the Board of Governors,[61] effective June 13, 1986.

/s/ WILLIAM W. WILES
William W. Wiles
Secretary of the Board

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eliminate the need to address specific legal issues. Thus the limitations proposed by NatWest should not necessarily be viewed as being mandated by the statute in every case.

61 Voting for this action: Vice Chairman Martin and Governors Rice, Seger, Angell and Johnson. Chairman Volcker abstained from this action. Absent and not voting: Governor Wallich.